S. HRG. 100-857

THE FIRST REPUBLICBANK OF TEXAS ASSISTED MERGER

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

THE MERGER OF THE NORTH CAROLINA NATIONAL BANK AND THE FIRST REPUBLICBANK OF TEXAS, THE ROLE OF TAX BENEFITS AND THE ASSUMPTION USED FOR CALCULATING THE ULTIMATE COST TO THE FDIC

AUGUST 11, 1988

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THE FIRST REPUBLICBANK OF TEXAS ASSISTED MERGER

THURSDAY, AUGUST 11, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:00 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Sanford, Graham, Wirth, Garn, Heinz, D'Amato, Hecht, Gramm, Bond, and Chafee.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The Committee will come to order.

Mr. Chairman, we are delighted to see you. In my judgment, you are doing an excellent job as Chairman of the FDIC under extraordinarily difficult trying circumstances, the most difficult circumstances I can recall in the 31 years I have been on this Committee.

The arrangement that you made in connection with the RepublicBank of Texas, which is the reason we're here this morning, as you know, is one that is very interesting and I think that the Committee should have an opportunity to understand it because it is so critical and it sets a number of possible precedents.

In this case, as I understand it, you had a number of options and a number of institutions which were interested and active here. You selected the North Carolina National Bank [NCNB] and you made an arrangement in which they would put up 5 percent of the capital roughly, $210 million; they get 20 percent of the stock, 100 percent of the voting stock; no liability for the bad loans. The FDIC takes the full liability for $5 billion of bad loans, puts up 95 percent of the capital.

As I understand it, the biggest gain within the NCNB is one that's a little obscured and that is the potential tax benefits which could be perfectly colossal if I can believe what I read. They can add up to well over $1 billion for NCNB.

On the other hand, there's indication here that there's also a very large downside possible for NCNB. They put up $210 million but that's only the beginning. This is a bank that has had a good record but they have also had some difficulties and their return on their assets, for example, as I understand it, is less than some of the other regionals and while they have grown rapidly, some people feel they may have grown too rapidly.

What concerns me more than this instant case is the future of your organization, the Federal Deposit Insurance Corporation. As you know, we've had 6 pretty good years economically—7 pretty good years economically I should say, and we are due for a recession. We may not get one. Some people say we'll never have another recession, but I wouldn't be too sure of that.

In view of the fact that even your fine institution, run as ably as you've run it, is having some difficulties now, I have great concern about what's going to happen if we move into a recession. That's what the FDIC is for. Anybody can handle it, of course, when we're doing well. We've had a very serious recession in Texas and some of the other parts of the country, but nationally it hasn't hit yet.

So that's the kind of thing I want to get into to determine how safe and sound FDIC is and whether it can continue to do its job even if we run into greater difficulties.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Chairman Seidman, your testimony today describes what appears to be a very creative and innovative solution to a large and difficult problem—the failure of a huge bank holding company. The FDIC is projected to outlay $4 billion and a final loss between $2 billion and $3 billion. That's a lot of money even by government standards.

The transaction raises a number of questions that I hope will be addressed today, such as the role of tax benefit, the strategy of closing unhealthy banks and the assumptions used for calculating the ultimate cost to the FDIC.

I'm also pleased to see the success of the bridge bank tool we tried to give the FDIC in 1986 but which didn't become law until we passed CEBA last year. This tool might need to be strengthened by the FDIC proposed legislation that Senator Proxmire and I introduced yesterday by request. That is also something I hope we can learn more about today and I look forward to your testimony.

The CHAIRMAN. Thank you. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I have no prepared opening statement. I look forward to hearing from the chairman on the issue of great importance. I might say that I have had through my previous interest in the development of a regional banking system in the south considerable involvement and exposure to the leadership of NCNB. I have been consistently impressed with its professionalism and quality of its both vision and execution. I am persuaded that Mr. Seidman chose well in finding a partner who could help bring some stability to the situation with the Texas bank.

The CHAIRMAN. Thank you, Senator Graham.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. Let me commend you for holding this hearing.

Perhaps our distinguished witness, Mr. Seidman, could allay some of the concerns that many of us share. To be quite candid, I am disturbed by the transaction for two reasons. First, it continues a precedent I believe which is too big to fail. The bank is too big to fail. We saw that kind of thing take place when Continental went under and now we see this.

Second, it creates a new precedent by giving away so much an retaining I think so little. This deal sends a message to the pool of potential investors upon which the solvency of both deposit insurance funds depends and I think the message is to shop around and there are some fat deals out there while the money lasts.

Now perhaps the FDIC sees itself in the position to spend these billions of dollars of finite resources in order to take care of an admittedly serious and enormous problem. However, I don't believe that the FSLIC has the luxury to use its dollar resources in this way and so where will the wise investor go? How will any economically motivated person respond to an opportunity to play one insurance fund and one troubled industry against the other to get the best deal? I think that's out there and it's taking place right now and I feel that this bailout trades a quick fix on the First Republic for serious problems down the road. I fear that this long-term problem of the FDIC and FSLIC are no closer to solution than they were before the First Republic bailout.

Mr. Chairman, I have a number of questions that during the question and answer period with some more specificity address some of these concerns.

I thank the chairman.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

Chairman Seidman, I would join with our distinguished chairman, Chairman Proxmire, in the kind words he said. I think that you have done an excellent job at a very difficult time. I happen to disagree a little bit with my colleague from New York. I think that you chartered some new ground and pointed in new directions, particularly in not protecting the holding company creditors. I noticed that that has been widely acclaimed by many commentators as perhaps being a necessary next step in the regulatory process.

The one thing that becomes clear to me as we look at this transaction more is that it is a very complicated one and we look forward to your testimony today to help us get a better understanding as to what the challenges were and how you saw the various opportunities. I think we can learn about this action, but it is of most interest to me, because it really does open the subject that I expect that this Committee will be considering at great length next and as I have mentioned in previous hearings to the chairman I hope we can begin with some hearings this fall, specifically on what we do with the deposit insurance system.

Do we need a complete restructuring? I think your actions here have certainly opened a number of questions. I know that you did put in a strong pitch for the legislation. We will be interested to hear your discussion of that as well and we look forward to working with the chairman and the ranking member on the appropriate legislative remedies.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first, I want to join in welcoming Bill Seidman back to this committee. He has done I think an excellent job in his tenure at the FDIC and it's unfortunate that he has so many problems on his watch and it needs to be said that he is not the creator of those problems. He has inherited them for a variety of reasons. Today as we examine the recent rescue of First RepublicBank Corporation, we're going to look at one of his biggest problems: a $4 billion bailout, that unfortunately, but undoubtedly will break the record for the most costly transaction in FDIC history.

Sad to say, this bailout comes on the heels of a number of other records set by the FDIC. The FDIC's bailout of some 203 banks in 1987 set an unhappy new record. The 1,624 problem banks confronting the FDIC at the end of 1987 also set a new record. The FDIC's anticipated loss for 1988 is the first loss in the FDIC's history, and that sets a new record. Along with those unhappy, unfortunate, unwished for records, we have the record losses that were referred to a minute ago in the thrift industry, and the record deficits of the FSLIC.

While those records may be different, they all play the very same tune—the "Federal Deposit Insurance Blues." It is this Senator's judgment that as we look at these specific problems that it is going to be up to the Congress to change that tune by looking at the Federal deposit system comprehensively and, as Senator Bond suggested, at the structure of our depository system in general as well.

We cannot continue to have an insurance system that has proven to be costly and unreliable. We cannot endure a depository system for the sake of this country that is not sound.

Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Before we begin, I have statements from Senators Dixon and Sanford for insertion in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as we hear the distinguished Chairman of the Federal Deposit Insurance Corporation, William Seidman, discuss the Federal Deposit Insurance Corporation-assisted acquisition of the First Re-

publicBank Corporation of Dallas, Texas by NCNB Corporation of Charlotte, North Carolina.

This is a huge transaction—even larger than the Continental Illinois package, and it sets a number of important precedents. I do not intend to pass final judgment at this time; I want to carefully review all the details of the deal. However, I do want to congratulate the Chairman of the FDIC for one very important component of the transaction—the fact that bondholders, as well as stockholders, will not receive any Federal assistance. I think it is essential not to extend the Federal safety net to creditors of the holding companies, and I am pleased to see that the FDIC shares that view. We have record numbers of banks closing each year. To the maximum extent possible, we must strive to see that those doing business with large banks do not receive more protection that those doing business at small banks. The knowledge that creditors of the holding company will not receive the benefits of the Federal safety net will help ensure the kind of market discipline that we need and must have.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sanford.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Mr. Chairman, I thank you for calling for this hearing. Due to the tremendous size of the NCNB-First Republic transaction, I think it is wise that we consider some of the details of the deal and some of its implications for the FDIC and the bridge bank legislation we passed last year in CEBA.

I would also like to welcome Chairman Seidman and to commend him and his colleagues for the excellent work they did in putting together this transaction. I have looked over the terms of the deal and discussed it at some length with NCNB and think it is an excellent deal for the FDIC, for NCNB, for North Carolina and for the country. It is a creative and innovative transaction which is exactly what I believe is needed, given the size and the complexity of the problem the FDIC faced in addressing the problems of First Republic.

I also want to commend the FDIC for acting quickly to stem the losses in what I believe could have become an ever bigger problem had the FDIC not stepped in and solicited bids for an assisted transaction. While many may question, particularly in hindsight, why approval was granted for InterFirst and RepublicBank to merge in the first place, I think the FDIC's action now is very positive. At a time when First Republic's debt was trading at only 11 cents on the dollar, it was imperative to take action to prevent the entire $27 billion value of the bank from being lost and becoming a burden on the FDIC.

In addition, I believe that the FDIC has put in place the right kind of incentives to encourage NCNB continually to increase its percentage holding in First Republic, while discouraging the "dumping" of assets onto the already flooded Texas market.

I know that NCNB has committed some of its very top and most talented personnel to Texas and I am confident that they will perform well in helping this major bank rid itself of bad loans and

start down the road to recovery. I have been consistently impressed with the quality of the top management at NCNB. It is an extremely well run bank and I am confident that NCNB will do an excellent job in Texas.

Again, I commend you, Chairman Seidman and your colleagues at the FDIC in putting together this very unique transaction and I look forward to your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sanford. Mr. Seidman, you can go right ahead. We're looking forward to your testimony.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman and Members of the Committee, I thank you for your kind comments.

I am pleased to testify today on the FDIC's assistance transaction involving the subsidiary banks of First Republic Corporation of Dallas.

I have submitted for the record my full written testimony in which I discuss the factors that led for the need for FDIC assistance for First Republic and have gone over in some detail that plan.

The CHAIRMAN. Without objection, your statement will be printed in full in the record.

Mr. SEIDMAN. Thank you, Senator.

I would like to take my few minutes now to make six points that highlight the important aspects of the FDIC solution to the First Republic problem.

NOT A BAILOUT

First, our assistance to First Republic was not a bailout. It was not a bailout. It was not a "too big to fail" situation. It was in fact a shutout. The shareholders and creditors did not benefit from Federal assistance. Instead, 40 banks were closed and we treated the owners and lenders of the First Republic Holding Company as any other failed company would have been treated.

The Federal safety net was limited to the banks and did not extend to the holding company. This encourages an efficient capital market for the banking system. I want to particularly express my appreciation to the committee and Senator Garn for passing the bridge bank legislation which allowed us to take the actions that we took in this case.

Second, notwithstanding the fact that over 40 banks were closed in one evening, the customers of the First Republic system were not inconvenienced by the assistance that we provided. First Republic offices remained open according to their normal schedules and no services were disrupted. Given the scope and complexity of the assistance transaction, this accomplishment I believe is a tribute to the cooperation among the FDIC, the Office of the Comptroller, the Federal Reserve Board, and the Texas banking authorities. The dedication and professionalism demonstrated by the staffs of these entities I believe deserve special recognition.

Third, this transaction marks the first time that an initial assistance package for a troubled major banking organization included bringing in a new management team, not just at the top but throughout the senior operations of the institution. NCNB has sent some of its best people to Texas. These individuals are experienced in handling the problems of large holding companies and they are now at work addressing the First Republic problems. They gave us confidence that the difficult task of turning the organization around will in fact be accomplished.

EMERGENCY CONSOLIDATION LEGISLATION NEEDED

Fourth, our handling of this problem has made clear the urgent need for the emergency consolidation legislation we have proposed and we thank you for introducing that, Mr. Chairman and Senator Garn. If such a law is not passed, future holding company financing will seek to prevent the FDIC from carrying out the procedures successfully used in the First Republic transaction. I think this is especially important and makes more urgent the need for this legislation.

If we cannot carry out the First Republic type transaction, our assistance will be more costly and less effective and, as you know, we consolidated the banks in order that multibank holding company systems use all their banking resources to reduce the loss to the FDIC fund.

Fifth, the FDIC chose a solution to First Republic's problems that was the least costly available among five qualified bidders. In spite of that fact, our total assistance will probably turn out to be the most expensive ever provided. We have estimated it at $2 billion to $3 billion, given what we know at this time.

This makes it very important that we examine what we have learned from dealing with this and the other extraordinary deposit insurance problems—both ours and the FSLIC's—over the last few years.

Early this year, the FDIC began a comprehensive study called "A Deposit Insurance System for the 1990's." This study is designed to help find ways to improve the Federal deposit insurance system. We have met with groups throughout the country and with the academic community to look for better ways to do the deposit insurance system task. We plan to make our suggestions available no later than December.

Sixth, it is important to emphasize that despite the cost of this assistance transaction and two other large assistance transactions which we have completed this year, and the scores of other failures we have and will handle, the FDIC fund remains viable, probably ending the year with a reduction of somewhere between 10, 12 and 13 percent. Thus we believe we are ready and able to handle all the insurance costs that we can foresee under current conditions.

Mr. Chairman, I'd be pleased to respond at this time to any questions that you and the members of the Committee have. Thank you.

[The complete prepared statement of Mr. Seidman follows:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

THE FDIC-ASSISTED ACQUISITION OF THE SUBSIDIARY BANKS OF FIRST REPUBLICBANK CORPORATION, DALLAS, TEXAS, BY NCNB CORPORATION, CHARLOTTE, NORTH CAROLINA

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

10:00 a.m.
August 11, 1988
Room SD-538, Dirksen Senate Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today on the Federal Deposit Insurance Corporation's assistance transaction involving the subsidiary banks of First RepublicBank Corporation, Dallas, Texas.

First, we will provide some background on First Republic and the interim assistance that was provided in March, 1988. Then, we will turn to a description of the assisted acquisition of the banks by NCNB Corporation, Charlotte, North Carolina, that was approved by the FDIC Board on July 29, 1988. Finally, we will comment briefly on the FDIC's proposed emergency consolidation legislation.

BACKGROUND ON THE FIRST REPUBLIC BANKS

As of year-end 1987, First RepublicBank Corporation was the 14th largest bank holding company in the United States with over 160 banking offices throughout Texas. It also was the largest banking organization headquartered in Texas and in the Southwest with $28.4 billion in assets as of March 31, 1988. First Republic's subsidiary banks had a strong presence in the market areas of Dallas, Fort Worth, Houston, Austin and San Antonio. In addition, First Republic owned a bank in Delaware which was primarily a credit card operation.

The First Republic Banks had major correspondent relationships with almost 1,100 banks located throughout the United States, but principally in the Southwest. They acted as depositories for their correspondents and provided check clearing, transfers of funds, loan participations, and custodial, clearance and investment advisory services.

The First Republic Banks also had many corporate relationships and held uninsured deposits and non-deposit liabilities of about $12 billion, including inter-bank funding of about $6.4 billion. In particular, First RepublicBank Dallas was a major commercial lender in the region. The First Republic system as a whole had approximately 20 percent of the total loans made by commercial banks in the state. It had approximately 125,000 loan customers and unfunded loan commitments of over $9.1 billion. In addition, many corporate customers relied on the First Republic Banks for vital services.

In July, 1988, the First Republic Banks' trust departments represented the largest trust operation in the Southwest. They managed over $50 billion in assets for over 25,000 customers.

Given First Republic's size and presence in the Southwest, it was evident that an abrupt discontinuation of these deposit and other commercial banking services would have had the potential of seriously disrupting those market areas. The potential for widespread trouble in the financial system was more likely in light of the severely depressed economic conditions in the Southwest.

Like many other banking institutions in Texas, First Republic (and its predecessors, Republic Bank Corp. and InterFirst Corp.) suffered serious losses during the past two years, made worse by the troubled regional economy. As these losses first appeared, many of the company's funds providers (particularly Eurodollar funding and other overseas sources) began to abandon the system. In part to replace these funds, the downstream affiliate banks of First Republic supplied their funds to enable the lead bank in Dallas to continue to operate.

In December, 1987, First Republic announced that it expected to suffer a loss of between $325 million and $350 million for the fourth quarter of that year. As a result of the announcement, the holding company and the lead banks in Dallas and Houston began to experience even more significant funding problems. The system began to draw on a back-up credit line aggregating just over $2 billion provided by seven major banking companies.

In late January, 1988, First Republic announced that it had suffered a fourth quarter loss of $347 million, bringing its 1987 losses to a total of $656 million. It also announced that $3.9 billion (16 percent) of the loans in the First Republic system were nonperforming at the end of 1987.

This continual disclosure of adverse information accelerated the decay in First Republic's position in the major funding markets. Retail depositor concerns began to appear. Many of the First Republic Banks were experiencing a steady decline in depositor confidence, and demand-deposit and correspondent business began exiting the system at significantly increased rates.

By late February, First RepublicBank Dallas began experiencing a depositor run. In a five-day period ending February 24, the Dallas bank's customer deposits declined by about $750 million, or approximately 15 percent of its total deposits. By March 1, the First Republic Banks as a whole already had lost more than $1.8 billion in deposits during 1988.

In early March representatives of First Republic formally sought assistance from the FDIC. On March 15, 1988, as a result of continuing outflows, the Dallas bank's funding needs exceeded its $2 billion line of credit with the

lending banks. To meet its funding requirements and repay the lending banks, the Dallas bank was forced to borrow $2.6 billion from the Federal Reserve Bank of Dallas.

By March 16, First RepublicBank Dallas was about to fail as news of the move to the Fed window accelerated fund withdrawals. This raised a concern that an uncontrolled collapse of the First Republic system might present a real threat to the financial system in Texas and nationally.

INTERIM ASSISTANCE

On March 17, 1988, the FDIC, after consultation with the Federal Reserve and the Comptroller of the Currency, announced its interim assistance plan for First RepublicBank Corporation, Dallas, Texas, involving a $1 billion six-month loan to the two largest banks in the First Republic system. The announcement included an assurance to depositors and general creditors of the First Republic Banks that in resolving the First Republic situation, bank depositors and bank creditors would be protected and that services to customers would not be interrupted. The FDIC specifically provided no assurance to creditors of the First Republic holding company or other non-banking subsidiaries. Further, these assurances related only to depositors and creditors other than the First Republic Banks themselves. That is, the inter-bank funding from one First Republic bank to another was not protected by the FDIC assurances.

In exchange for the assistance, the First Republic holding company guaranteed the $1 billion loan and collateralized that guarantee by pledging the shares

of 30 of its bank subsidiaries. This loan was further guaranteed by each of the First Republic Banks. First Republic also agreed to substantial restrictions on its operations, management, and policies.

The nature of the assurances provided by the FDIC were that, as it acted to provide a long-term solution for the First Republic situation, the FDIC would arrange for a transaction that resulted in the depositors and creditors continuing to have deposits in and claims against an operating bank as a result of open-bank assistance transactions or a variation of one of its traditional purchase-and-assumption transactions.

It is important to understand the legal basis for the granting of such assurances. Section 13 of the Federal Deposit Insurance Act specifies the various alternatives available to the FDIC in assisting failing or failed banks. Two of the alternatives are: (1) providing direct assistance to the banks to prevent their closing, or (2) providing assistance to another entity to facilitate the acquisition of the banks. Such alternatives generally have the effect of protecting depositors and other creditors of the banks. If any alternative other than paying off insured depositors and liquidating the assets of the failed bank is to be exercised, normally the FDIC's cost in exercising such alternative must be no greater than the cost of liquidating the banks.

However, the FDIC also may grant assistance in those instances where the failing bank is found to be essential to the community in which it operates. Based upon the facts and circumstances described above, the FDIC Board made the determination of essentiality.

With respect to First Republic, the FDIC, in consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, determined that severe financial conditions existed that threatened the stability of a significant number of insured banks, as well as insured banks possessing significant financial resources. In making this determination, the FDIC Board of Directors did not extend deposit insurance coverage to uninsured depositors and creditors. Instead, the Board committed itself to accomplishing a long-term resolution of the First Republic problem in a manner that would not result in loss to depositors or other general creditors of the bank.

The interim assistance accomplished its desired effect. Deposit outflow slowed considerably. However, First Republic's overall financial condition continued to deteriorate due primarily to nonperforming real estate loans. First Republic reported a 1988 first quarter loss of $1.5 billion and a second quarter loss of $758 million.

ASSISTED ACQUISITION BY NCNB CORPORATION

On July 29, 1988, the Texas subsidiary banks of First RepublicBank Corporation were closed and the FDIC agreed -- after considering the various bid proposals -- to sell the banks to NCNB Corporation. Upon the banks' closings, the FDIC organized a bridge bank, NCNB Texas National Bank, to assume the banks' deposits and other liabilities and to acquire certain of the banks' assets.

The bridge bank will be run under contract by NCNB management for two to three months, until the requisite legal documentation is prepared and a final accounting of the banks' financial condition is completed. At that time, NCNB will acquire a 20 percent interest in NCNB Texas National Bank. The assurances given by the FDIC in March, 1988, to protect all depositors and general creditors of the banks also will continue until that time.

The bank will be operated as a bridge bank until the earlier of three years or the time at which NCNB acquires a majority interest in the bank. The bridge bank authority was created as part of the Competitive Equality Banking Act of 1987 in order to permit the FDIC to "bridge" the gap between a failed bank and a completed purchase-and-assumption or other transaction.

The obligations of the failed banks' parent companies, First RepublicBank Corporation and IFRB Corporation, including approximately $1.2 billion in debt and preferred stock, will remain with the parent companies. NCNB Texas National Bank will not assume any of the obligations of the holding companies.

Capital Infusion. NCNB Corporation will acquire 100 percent of the voting stock of NCNB Texas National Bank. The stock will represent 20 percent of the total equity, for a minimum investment of $210 million in cash and a maximum of $240 million. The FDIC will acquire nonvoting stock representing 80 percent of the total equity, for a minimum investment of $840 million in cash and a maximum of $960 million. The equity infusion of at least $1.05 billion and the direct assistance, described below, that will be provided by the FDIC will create an institution with at least 6.0 percent primary capital.

NCNB Corporation will have the exclusive, nontransferable option, exercisable at any time during the first five years, to purchase the FDIC's 80 percent interest. The exercise price per share will be the amount of the FDIC's original investment per share plus, in the first three years, 115 percent of the net increase in book value per share, with the premium increasing to 120 percent in the fourth year and 125 percent in the fifth year.

FDIC Assistance and Cost. Once the assistance program is implemented, all loans, real estate properties and other assets acquired by NCNB Texas National Bank, including all performing and nonperforming assets, will be written down to their market value, as agreed between the bank and the FDIC. The FDIC will provide direct assistance to NCNB Texas National Bank in a combination of cash, notes, and debt relief, in an amount sufficient to eliminate the negative net worth. The FDIC's initial outlay for the transaction is expected to be approximately $2 billion, in addition to the $1 billion loaned to the First RepublicBank banks in March, 1988. An additional $1 billion is estimated to be required to meet the writedown of additional loans found to be classifiable and thus "put" to the special asset pool (described below).

Thus, the Corporation's total outlay after consummation of the permanent assistance program is estimated to be $4.0 billion. The FDIC's net cost for the transaction, however, is expected to be significantly lower than its total outlay. Our preliminary estimate of the net cost is $2 to $3 billion. But, we must emphasize that this is a preliminary estimate subject to change as a result of a number of factors which are not fully quantifiable at this time. The ultimate cost to the FDIC will depend on the amount of collections on and the value of the assets in the "special asset pool"; the amount of troubled

assets transferred to the separate asset pool; the amount of dividends receive by the FDIC while it holds stock of NCNB Texas National Bank; and the price the FDIC receives on the sale of its stock in NCNB Texas National Bank to NCNB or, should NCNB fail to exercise its option to purchase the FDIC's stock, on sale to the public or to a third party.

Separate Asset Pool. The assets transferred to NCNB Texas National bank from the First Republic banks included a substantial volume of troubled loans, real estate properties and other troubled assets. A major feature of the financial assistance program is the transfer of most of those assets to a separate asset pool in the new bank. The troubled assets will be transferred to the pool, marked down to fair market value, and accounted for by separate bookkeeping entry within NCNB Texas National bank. The assistance agreement also includes a provision permitting NCNB Texas National Bank to transfer subsequently classified assets to the separate asset pool. This "put" provision may be exercised at the end of the one-year and two-year periods after the date the assistance transaction is consummated. Any disputes on whether an asset should be classified and therefore "put" will be decided by arbitration.

NCNB Texas National bank will be responsible for the administration and collections of the asset pool under the supervision and direction of the FDIC. While the pool remains owned by NCNB Texas National Bank, it will be administered as a separate profit center. The new bank will assign a full-time dedicated management team to manage collection and liquidations of the assets in the pool, with incentive programs based on performance of the pool assets. In addition, the new bank's share of any ultimate gains on the pool will be tied to efficiency of pool administration and pool performance.

At the end of three years, if, as expected, NCNB Corporation has increased its ownership of NCNB Texas National Bank to 51 percent, the entire remaining asset pool may be spun off to a new FDIC-owned liquidating bank operated by NCNB Texas National Bank under continuing incentive programs.

NCNB Corporation's Management. As an essential part of the program to revitalize the First Republic banks, NCNB Corporation immediately assigned an initial team of more than 250 experienced staff to work with existing management and staff of the former First Republic banks.

After implementation of the program and while NCNB Corporation is a minority owner, it will continue to manage the new bank substantially as if it were its subsidiary. Under the controlling agreement, however, NCNB must consult with the FDIC regarding decisions on business operations and strategies, must provide reports to the FDIC and may not take any action objected to by the FDIC.

Upon NCNB Corporation's exercise of the purchase option to increase its ownership to 51 percent or more, it will assume full control of the new bank. Once NCNB Corporation increases its ownership to 80 percent or more, it will be required to purchase the FDIC's remaining interest at the agreed premium.

Chronology of the Transaction. The decision to proceed with the restructuring and recapitalization plan proposed by NCNB Corporation followed extensive negotiations with several interested parties. The FDIC Board of Directors requested and received two separately prepared analyses on the proposed plans. One was prepared by the internal staff of the FDIC and the other by

Dillon, Read & Co., an investment banking firm retained by the FDIC. The conclusions reached in the two separate analyses were substantially similar.

In the late afternoon of July 29, 1988, the FDIC Board of Directors decided that NCNB Corporation's plan represented the most effective, most viable, and least costly approach for preserving existing banking services in the affected communities and promoting stability in the Texas banking system. Following this determination, the FDIC notified the Office of the Comptroller of the Currency and the Texas Commissioner of Banking that it would not provide additionnal assistance to the subsidiary banks of First RepublicBank Corporation and would not renew its $1 billion loan to the First Republic Banks when it became due in September.

In response to the FDIC's decision, the Comptroller of the Currency notified the Federal Reserve Bank of Dallas that First RepublicBank Dallas, N.A. was no longer a viable bank. The OCC's notice was based on continuing severe loan losses at First RepublicBank Dallas, N.A. which already had more than depleted the institution's equity capital, the FDIC's decision not to provide open-bank assistance, a determination that First RepublicBank Dallas, N.A. would be unable to meet its daily funding needs without the continuing substantial support of the Federal Reserve Bank, and other factors.

The Federal Reserve Bank of Dallas then requested repayment of the Dallas Bank's borrowings. First Republic Bank Dallas, N.A. was unable to repay its obligations, which resulted in its closure by the OCC and the appointment of the FDIC as receiver.

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When the Dallas bank closed, virtually all the other First Republic Banks were providing fed funds to the bank. These obligations were not insured, and had been subordinated to the obligations of the Dallas and Houston banks to the FDIC. Receivership certificates were issued for these uninsured, subordinated obligations, which were then valued based upon the losses in the Dallas and Houston banks. Further, under the terms of the emergency assistance from the FDIC, the insolvency of the Dallas bank was an event of default that resulted in the FDIC's demanding immediate repayment of its $1 billion loan. This loan had been guaranteed by the subsidiary banks. The amount of the banks' guarantee was charged against their capital accounts. Losses as a result of these charges and other intracompany transactions rendered the other banks insolvent. Those banks were then closed by their chartering authorities, the FDIC was appointed receiver, and the transfer of assets and liabilities of the failed bank to the newly created bridge bank was approved by the appropriate state and federal courts.

PROPOSED EMERGENCY CONSOLIDATION LEGISLATION

Our experience with First Republic and other recent transactions suggests that the FDIC's proposed emergency consolidation legislation (previously distributed to the Committee members) is urgently required so that all parties will operate under the certainty of federal statutory law. If such a law is not passed, future holding company financing may seek to prevent the FDIC from carrying out the procedures used in the First Republic transaction. The proposed legislative measure would establish special procedures for dealing with failing banks in multibank holding companies to ensure that all banks in the holding company support the insurance fund.

Multibank holding companies generally coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with that bank individually.

The proposed emergency procedures are designed to ensure that the appropriate banking assets of a multibank holding company system are applied to assist a failing subsidiary bank prior to requiring the expenditure of FDIC funds. In essence, it would facilitate FDIC efforts to prevent the federal safety net from being extended to holding companies and eliminate the increased cost to the insurance fund that banks in unit banking states can impose, when compared with banks in branching states.

Mr. Chairman, I would be pleased to respond at this time to any questions you or the other members of the Committee may have.

The CHAIRMAN. Thank you very much, Mr. Chairman.

Chairman Seidman, some people suggest, including an article that appeared in the U. S. News and World Report this week, that the real mistake was in letting the Interfirst Corporation merge with the Republic National Bank in June of 1987.

[Copy of magazine article follows:]

BUSINESS

The bailout of First RepublicBank is a done deal–but there's more to the story

Anatomy of a bank disaster

The two images, of businessmen beaming into bright TV lights, are eerily similar. Just over a year ago, executives of two deeply troubled Texas banks strode confidently up to a podium bristling with microphones and expressed heartfelt thanks for the government's approval of their merger into a brand-new company, called First RepublicBank Corporation, the biggest bank in the Lone Star State. The government O.K., the bankers said, was the right response to the prolonged Texas banking crisis. It didn't turn out that way. For when a new set of executives faced the TV cameras just a few days ago, it wasn't to provide a progress report on the big new Texas bank but to announce its death. The funeral arrangements will not be cheap: With the government putting up roughly $4 billion and small likelihood it will recover much of that, the story of First RepublicBank is the story of what seems certain to be the most expensive bank bailout in the nation's history.

It is, to be sure, a cautionary tale, a story of monumental miscalculations and official accedence—despite clear warnings of trouble—to some of Dallas's most influential money men. Through it all, though no one can provide precise evidence of influence peddling, runs a strong undercurrent of political intrigue. What is clear at this juncture, as the new team of businessmen from NCNB Corporation of North Carolina attempts to resurrect a healthy bank from the ashes, is that something went drastically wrong at First RepublicBank, whose creditors are now trying to accommodate themselves to the loss of hundreds of millions of dollars.

An examination by *U.S. News* of the whys and wherefores behind America's biggest bank bailout has yielded some of the answers. Relying on voluminous government documents and interviews with more than 100 regulatory officials, banking executives and other informed sources, the inquiry found that:

■ Federal banking regulators rejected an acquisition offer for one of the two banks merged to form First RepublicBank that likely would have saved substantial government expense. The offer, by Security Pacific National Bank of California, was "serious," according to banking and government sources, and would have *paid* the government $50 million as an "insurance premium" on the health of the new bank. It would also have obligated the new parent company, not the government, to pay up to the first $1 billion in loan losses over five years. Only after that would the government have been liable.

■ The Office of the Comptroller of the Currency, which recommended approval of the merger of InterFirst and RepublicBank into First RepublicBank Corporation, failed to conduct a full review of RepublicBank's troubled loan portfolio and relied instead on favorable information from RepublicBank executives, an incomplete examination of some bank records and a review of the bank's books that, while thorough, was a year out of date.

■ Several bank examiners assigned to evaluate the merger proposal were told, even before they conducted their hasty and incomplete review of RepublicBank's books, that the merger with InterFirst would be approved. "There was no doubt the decision had been made to approve it," a banking source said. "[The examiners] did not see how this deal was going to work, but others in the organization did."

■ Vice President George Bush and Texas Senator Lloyd Bentsen, the Democratic vice-presidential candidate and chairman of the Senate Finance Committee, were briefed by bank officials on the status of the merger application, which had the support of some of the most politically influential people in Dallas—people who strongly advocated a "Texas solution" to the problems of InterFirst and RepublicBank and argued against a purchase of either by an outside bank. Treasury Secretary James Baker also was briefed on the merger proposal by senior regulatory officials and bank executives. All three men, who have close ties to senior officials of InterFirst and RepublicBank, say through spokesmen that they made no attempt to influence the disposition of the merger application.

"A sweetheart deal." It's highly possible that a viable banking corporation will be built from the wreckage of First RepublicBank—but at a considerable price. The bailout just announced requires the Federal Deposit Insurance Corporation to put up about $4 billion for an 80 percent stake in the new bank—NCNB Texas National Bank; the new parent, NCNB, a rapidly growing and well-run "superregional" bank, will put up as little as $210 million for the remaining 20 percent. And if NCNB cannot raise all of the money, Texas billionaire H. Ross Perot has told NCNB Chairman Hugh

THE REFEREES

■ Governors of the Federal Reserve, acting on recommendations from their own staff, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, voted, after intense debate, to approve the merger

■ The Office of the Comptroller of the Currency, the primary bank regulator, failed to do a full review of RepublicBank's books, which could have disclosed the scope of problems with the bank's troubled real-estate loan portfolio

■ Officials from the Federal Deposit Insurance Corporation, which will put up the $4 billion to allow the bailout of First RepublicBank by NCNB Corporation, also recommended approval of the merger

THE PLAYERS

■ Gerald Fronterhouse, chairman and CEO of RepublicBank, which lost $450 million between 1981 and 1986, pushed hard for approval of the acquisition of cross-town rival InterFirst bank

■ H. R. "Bum" Bright, the largest shareholder in RepublicBank, initially proposed the merger with InterFirst, calling it a Texas solution to the protracted banking crisis in the state

■ Robert Stewart, chairman and CEO of InterFirst, which lost $1.2 billion between 1981 and 1986, contacted George Bush, James Baker and Lloyd Bentsen to ask their support for the merger

In the catbird seat: NCNB Chairman McColl's smile came at the expense of First RepublicBank's misfortune

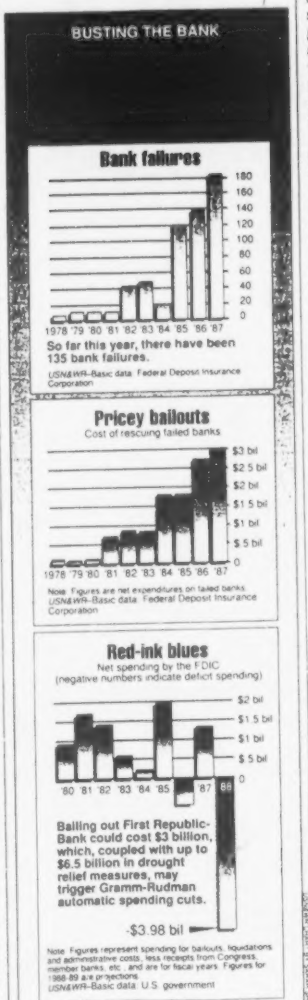
Open and shut: Escalator signs tell the story

legitimate. "Security Pacific was damned serious," says one well-placed source. "We were running heavy numbers on that deal." Because Security Pacific would have had obvious incentive to minimize loan losses, these sources say, it's possible that the deal would not have cost the FDIC a penny, though, of course, it's impossible to know. In any event, when officials of RepublicBank proposed that *they* acquire InterFirst, the Security Pacific proposal was discarded. Bank companies in New York and abroad that had approached RepublicBank about a possible acquisition also desisted when bank executives rejected their overtures, says H. R. "Bum" Bright, RepublicBank's largest shareholder.

Weaker parent. When Gerald Fronterhouse, the chairman of RepublicBank, and Robert Stewart, the chairman of InterFirst, flew to Washington in the summer of 1986 to pitch the merger for the first time, it was generally assumed that, while both banks had big problems, RepublicBank was the healthier. InterFirst, after all, had reported $1.2 billion in loan losses since 1981; RepublicBank tallied just $450 million over the same period and was projecting that it would not lose more than $229 million in 1987.

What has since become clear is that RepublicBank, the presumed-healthier parent, was much weaker than InterFirst, and this is why the comptroller's failure to conduct a full-scale examination of its books now seems so shortsighted. There were plenty of signs to indicate caution. For example: On a scale of 1 to 99, rating the financial health of Texas banks, Alex Sheshunoff & Company, a respected Texas firm, gave the flagship of RepublicBank, RepublicBank of Dallas, a measly 4. Sources familiar with RepublicBank's operations say bank officials were simply not writing off nonperforming loans in its extensive real-estate portfolio, which had deteriorated drastically in the depressed Texas market. Indeed, in some cases where InterFirst and RepublicBank were joint lenders on troubled real-estate projects, bank sources say, InterFirst was writing off the loans while RepublicBank was not.

Additionally, regulatory sources say, RepublicBank's appraisals on real-estate assets were "months and months" out of date, reflecting inflated values—a fact that surely would have been discovered by a thorough, up-to-date examination of the books and the loans on them. "If they knew RepublicBank was in trouble," says a source familiar with the regulatory procedure, "they should have done a full-blown exam. You don't approve a merger of this magnitude until you know the extent of the problems." Says a senior official from the Federal Reserve, which relied heavily on the report of the Comptroller's Office in deciding to go forward with the merger: "I *do* wish we had had better information." Clarke's response? "The reason we didn't do a full-scale review was because we had done one the previous year." He says he's not sure a more thorough review would have helped. "I'm not going to tell you that if we had done a look-under-every-rock-type examination we wouldn't have found additional losses at the time. On the other hand, I can't tell you we would have."


BUSTING THE BANK
Bank failures
180
160
140
120
100
80
60
40
20
0
1978 '79 '80 '81 '82 '83 '84 '85 '86 '87
So far this year, there have been 135 bank failures.
USN&WR–Basic data: Federal Deposit Insurance Corporation
Pricey bailouts
Cost of rescuing failed banks
$3 bil
$2.5 bil
$2 bil
$1.5 bil
$1 bil
$.5 bil
0
1978 '79 '80 '81 '82 '83 '84 '85 '86 '87
Note: Figures are net expenditures on failed banks.
USN&WR–Basic data: Federal Deposit Insurance Corporation
Red-ink blues
Net spending by the FDIC
(negative numbers indicate deficit spending)
$2 bil
$1.5 bil
$1 bil
$.5 bil
0
'80 '81 '82 '83 '84 '85 '87 '88
Bailing out First RepublicBank could cost $3 billion, which, coupled with up to $6.5 billion in drought relief measures, may trigger Gramm-Rudman automatic spending cuts.
-$3.98 bil
Note: Figures represent spending for bailouts, liquidations and administrative costs, less receipts from Congress, member banks, etc., and are for fiscal years. Figures for 1988-89 are projections.
USN&WR–Basic data: U.S. government

Greased deal? Whether or not better information would have made a difference in approving the merger is, perhaps, the most intriguing question of the many in the strange saga of First RepublicBank Corporation. Though there was intense debate among senior personnel within the Comptroller's Office and the Fed, at least some of the regulatory staff assigned to analyze the proposed merger say they believe the deal had been greased. "I told people that we shouldn't approve it," says a government official with firsthand knowledge of the merger proposal. "But the people in middle management felt that the powers that be were going to approve it."

Certainly, there were grounds for such suspicions, even though they may ultimately have been unfounded. "I've been particularly sensitive about [matters involving Texas banks] with Jim [Baker]," says Clarke, "because Jim has a lot of friends in Texas. . . . So I think it's important to keep him advised." Clarke emphasizes that Baker has never sought to influence any regulatory matters.

The pressure from *bank* officials was hard to ignore, however. Top executives of RepublicBank and InterFirst were friendly with Bush, Baker and Bentsen. For the three years before he became Ronald Reagan's Vice President, Bush worked as a $75,000-a-year consultant and director of InterFirst. Bum Bright is a Bush fund raiser; Baker's cousin, Preston Moore, sat on the board of First RepublicBank in Houston until March of this year. And Bentsen, since 1980, has received a total of $30,000 from political-action committees of both banks. Bush, Baker and Bentsen, says one knowledgeable source, "were called to keep them informed and to explain that this was a good deal for Texas. [The banks] were building support to get the deal done. There was no question but that the good-old-boy system facilitated this process, but it was *not* the deciding factor." Neither bank nor regulatory sources can cite evidence of political pressure, and spokesmen for Bentsen and Baker—acknowledging that the two may have discussed the proposed merger with bank and regulatory officials—say no pressure was exerted. A spokesman for Bush says the Vice President "has absolutely no recollection of the topic." Still, some well-placed sources say the regulators' mere knowledge of these politicians' interest may have been enough to push the deal over the top. "It's like believing in the tooth fairy," says House Banking Committee Chairman Fernand St Germain, "if you think that politics didn't have an effect on the decision." ■

by Liz Gaffney

The CHAIRMAN. Do you believe that the condition of Republic National Bank was thoroughly examined at that time, at the time of the merger?

Mr. SEIDMAN. The condition of the bank was clearly worse than any of us knew.

The CHAIRMAN. Then was it, in your view, a failure to make an adequate and comprehensive and accurate evaluation?

Mr. SEIDMAN. Well, that was the Comptroller's area and I'm not really competent to comment on what he did. I think he has said, as I have just said, that the condition of the bank was worse than any of us knew.

The CHAIRMAN. Well, it seems to me that if that's the case that there's something wrong with the audit and it wasn't sufficiently accurate and so forth, or is it a matter of judgment that that can happen because you can't tell whether a loan is going to go bad?

Mr. SEIDMAN. Well, Mr. Chairman, auditing is always looking back at the past, not at the future, and one can't make a continuous audit. So, there is always room for an audit to not be up to date. In this case, conditions changed rapidly and adversely after the merger took place.

The CHAIRMAN. Did you support the merger at that time?

Mr. SEIDMAN. I supported the merger. We had no direct responsibility, but our opinion was requested and we supported it. I would be happy to give you the reasons for that.

The CHAIRMAN. What were they?

Mr. SEIDMAN. We knew that both of these banks were in a difficult situation. We thought that combined they could raise new capital, which they did, about $200 million, and that combined they could operate more efficiently, and they did, saving about $100 million a year. Given those two additions, we thought that they had a reasonable chance to succeed as a merged bank. They would have more capital and less operating expenses.

Unfortunately, that was not enough to overcome their problems. It is our view that, if we had allowed each bank to operate separately, each would have failed.

The CHAIRMAN. Why was the bid by Security Pacific for Interfirst Corporation turned down at that time?

Mr. SEIDMAN. It was not. That article is incorrect. Both we and Security Pacific gave the reporter our statements for the Record that that was incorrect. The reporter chose to quote unnamed sources and make that allegation. It is incorrect.

The CHAIRMAN. Now in his book entitled "Thrifts Under Seige," Dan Brumbaugh reminds his readers that as of 1984, FSLIC had shown only net additions to the fund. In that year the FSLIC insurance fund turned down for the first time—1984 was the first time. According to your testimony here and in the House hearings FDIC will experience a net loss for the first time in 1988. We hope that doesn't foreshadow a similar experience.

What differences exists between the state of the banking industry today and what we now know about the thrift industry of the last half decade that suggests the experience of the FDIC in the 1990's will differ from the experience with FSLIC?

Mr. SEIDMAN. I think the situations are basically different, Mr. Chairman. We have an 11th commandment which tells us not to

speak ill of our fellow banking associates and regulators, so I will try to be careful and abide by that in making my statements. But it is clear that capital in the S&L industry has been going down continuously since they began to get in trouble in 1982. In contrast, capital in the banking industry has been increasing. The banking industry profitability has not been as good as it was at one time but it has been a generally profitable industry. We expect industry profits this year, despite the problems in Texas, to be at record levels. The highest in history. So there is a basic difference between the directions of the two industries.

EXPECT A LOSS OF $2 BILLION

With respect to our funds, we do expect a loss this year in the $2 billion range.

The CHAIRMAN. That's a big loss. As you say, that's more than 10-percent of your reserves.

Mr. SEIDMAN. That's more than 10 percent of our fund, but to compare us with FSLIC, we would have to have that same loss for about 15 years in a row.

The CHAIRMAN. Or have a bigger loss for 3 or 4 years in a row.

Mr. SEIDMAN. That is true, sir, but there is a basic difference and I wanted to put that on the record.

The CHAIRMAN. Does forbearance on lesser developed country debt contain some of the same dangers that the thrift industry forbearance held?

Mr. SEIDMAN. There is no basic forbearance on foreign debt. The foreign debt situation has been handled by the banks' creating reserves against the potential losses in that area. Of those that have been evaluated, I would say I think we may have been somewhat slow in getting to the position we're in, but we now find the industry basically reserved 30 to 50 percent against potential losses in that area.

Our own calculations say that that is a reasonable reserve.

The CHAIRMAN. Thank you. My time is up.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Bill, I note in your press release that the FDIC will provide assistance to NCNB in the form of a capital contribution in order to eliminate negative net worth.

What is the size of this capital contribution and what is the form of the contribution?

Mr. SEIDMAN. The negative net worth is in the area of $2 billion and it hasn't finally been determined. It would depend upon the amount of classified loans that are put in the so-called bad loan pool. The form also will be determined in the next couple of months. It will either be cash or a note. So that the total amount that we will put in after all that is done will amount to, we estimate now, $4 billion.

NCNB HAS EXCEPTIONAL MANAGEMENT

Senator D'AMATO. Chairman Proxmire alluded to the question of the first merger and in respect to that it seems to me in reading your statement that you speak about NCNB having exceptional

management and I hope that is the case. The problem is there are some who wonder whether or not that management can handle an institution of this size with the kinds of problems and the complexity that exists and I say that in light of the fact that just a year prior we had another merger in which you put two troubled institutions together and a management team that was left in charge is now being replaced by another management team a year later with a far more difficult situation—or at least one that is recognized as being potentially much greater than what it was initially—so what is so different about the quality of these two teams?

I think it's a natural question. We'd have to kid ourselves and say, well, why do you see—what about the merger that took place first a year-plus ago?

Mr. SEIDMAN. First of all, there's a very substantial difference. In this case, our money is being invested. The merger that took place between Interfirst and First Republic was a private sector merger. We were not investing anything and we were simply agreeing to the transaction that the private sector had proposed. In making that judgment, given the circumstances then, we thought the management would be able to put those two banks together, make the savings that they had estimated, and raise more capital. They did. They weren't able to, however, save the bank and they weren't as good as we thought they were.

Senator D'AMATO. Well, what incentive—I think that's an important admission and I have always admired you for your candor. You're one of the few regulators in the position of real authority who is up front with this Committee and I think you always have been.

Mr. SEIDMAN. Thank you.

Senator D'AMATO. And the fact that you say, well, we didn't see this problem as being that big is much better than giving us glossy terms and double talk.

What incentive is there for NCNB to work out the problems of the bad bank? That's a concern that some of us have.

Mr. SEIDMAN. They have two incentives to work them out. First, they get a percentage of any gains that we can make on those loans and the people working on the loans will have incentives based on the sales they make of those loans.

Second, the sooner that they can get those loans out of the system, the sooner they can use that capital for banking where they can get a much higher return than they are now getting on those because now they are getting approximately government bond interest rates and, therefore, they can't make any money on them until they get the loans sold.

Senator D'AMATO. You obviously feel they do have the capacity then to manage the healthy part of the bank and work out the problems as it relates to these numerous—and many of them and large—those going into billions of dollars—the problems?

Mr. SEIDMAN. They have an outstanding management record. They have sent two of their three top people permanently to Texas to operate the situation, plus a great number of other managers. And while nothing in the future can be assured, we believe that they are competent to handle the situation and we are very encouraged already by the way they've moved in.

Senator D'AMATO. While I recognize the difference with respect to the FDIC and FSLIC, sometimes there is some experience that can be gathered one from the other and so let me ask you this last question. I see the little red light has gone on.

ESTIMATE THE SIZE OF THE TROUBLED ASSET POOL

What is the size—would you estimate the size of the troubled asset pool? I recognize that might even grow or it might be diminished. Second, FSLIC has developed a mechanism to avoid the dumping of real estate in Texas and that can be a very real problem. It can continue to depress and push down even further. Have you consulted with FSLIC to determine if your method of treating problem assets avoids the dumping problem?

Mr. SEIDMAN. We have discussed it with them. We have a basic guideline with regard to that. We appraise all those assets. On any large ones we get two appraisals, after which our people are only allowed to sell them below appraised value with special permission from the head of the division. Overall we average around 90-percent of the current appraised value. So we will not allow dumping.

We will, however, sell at appraised value and we will not hold real estate for gain.

Senator D'AMATO. And that first part of that question, do you have an estimate as to the size of the troubled asset pool?

Mr. SEIDMAN. The size of the pool is still not determined. The bank itself estimated the pool at their loan cost of $7.5 billion. We have had estimates up to $10 billion. It is probably somewhere between those two numbers, but we don't know and we won't know until NCNB determines which assets it is going to transfer to the pool.

Senator D'AMATO. Well, Mr. Chairman, I thank you and commend you for calling these hearings. Bill, I wish you the best of luck and I thank you for being as candid as you've been.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I'd first like to look back again at the Republic Interfirst merger. I understand that the Dallas Federal Reserve had recommended against that merger as being imprudent, that that recommendation was overturned by the Washington Fed.

Do you know that to be the case and, if so, what impact did that difference of opinion within the family of the Federal Reserve have on FDIC's decision?

Mr. SEIDMAN. I don't know that to be the case. I know that there was a great deal of discussion both in our shop and theirs about whether or not it was a sound judgment to merge these outfits. I think that's healthy. We don't want all our people to agree on everything and see what the boss wants and then agree with him. We are perfectly happy to have dissenting opinions.

Frankly, the basic rule used to be that banks couldn't merge unless they were one- or two-rated top banks. We have a different world now. We have a lot of banks in trouble and the basic idea is to judge whether a merger will have the potential for helping or hurting the banking system.

At the FDIC we felt that merging these two institutions gave us the potential for helping the system. If it didn't work, we wouldn't be any worse off than we had been if they hadn't been merged. In fact, we would be better off because there would be $200 million more capital between the losses and the insurance fund.

LIMIT ON DEPOSITS HELD OUTSIDE REGION

Senator GRAHAM. Moving to the current situation, under the southern regional banking program, there is a limitation of 20 percent on the deposits which a participating bank can hold outside the region. I understand that FDIC used its bridge bank authority to waive that 20 percent limitation in order to allow this transaction to proceed forward. Could you discuss the basis of granting that waiver and what reaction it has generated from other banks and bank regulators in the southern region?

Mr. SEIDMAN. Counsel informs me it was the Garn-St Germain procedures which allows us to override the 20 percent rule. I have not heard anything from other banks about that. The 20 percent was involved with consolidation of the statements with the tax ruling and many factors.

Senator GRAHAM. So you have had no comment from bank regulators or banks in the region in which NCNB has its domicile?

Mr. SEIDMAN. I haven't. No, we have not heard anything.

Senator GRAHAM. One of the concerns that has been alluded to is the effect that this had on the shareholders and the bondholders of the holding company. What effect do you believe this action is likely to have on the capital, including equity and debt market, for financial institutions? Will it have a chilling effect?

Mr. SEIDMAN. I think it will have a chilling effect on those who have been borrowing without sufficient capital to support the borrowing in their own right. It will restrict double leveraging, which is one of the real threats to the banking system. It will provide I think, that banks, much more frequently will finance directly than through holding companies. It will make it clear that holding companies are not protected by the safety net; therefore if the holding companies go into the securities business or other businesses, the Federal safety net will not protect them.

We think it is one of the most important changes in the banking system in terms of direction that has taken place in a long while, and obviously we think it's beneficial.

Senator GRAHAM. This would appear to be a situation in which a strong bank from a region of the country that has been generally economically prosperous has been married with a failing institution in a region of the country that's having economic problems.

What does this say about the traditional role of state-by-state, more recently region-by-region, barriers to banking as opposed to movement towards more of a national interstate banking system?

Mr. SEIDMAN. I believe it indicates that we are moving to a national interstate banking system rather rapidly. I think it proves some of the benefits because when one area is in trouble another area can bring capital in and improve the overall system. I think it's beneficial for banking.

Senator GRAHAM. Mr. Chairman, I know my time has expired, if I could just ask one last question.

This committee recently reported out legislation modeled after the National Economic Commission which would set up a similar commission to look at the issue of thrifts and FSLIC. There's been a proposal to expand this Commission's agenda to also include commercial banks and FDIC.

What do you think would be the value of a special National Commission to look at commercial banks and FDIC?

Mr. SEIDMAN. We certainly don't oppose that. As I've indicated in my testimony, we are doing that ourselves right at the moment. I will say that I think the S&L and FSLIC problem is far more urgent and needs action promptly. I would hate to see that held up for too long while we dealt with the FDIC. But we certainly don't object. In fact, we ourselves are looking at it. We think there are improvements that need to be made in the system.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman. To follow up on the next to last question of Senator Graham, would you sort of lay out the rationale for protecting bank creditors but not holding company creditors? You talked a little bit about the results. I have seen, as I indicated, some very favorable comment, and I think it might be helpful for us to have you express your rationale.

DEPOSIT INSURANCE

Mr. SEIDMAN. Basically, we believe deposit insurance is to protect bank depositors. It is a Federal intrusion in the private sector which is clearly warranted and the people want, but it ought to be limited to that and not extended beyond that. In the past, it has been extended beyond that, and that has given the marketplace the feeling that anything that a holding company does, whether it is directly banking or not, would be protected by the Federal Government through its insurance funds. We think that sharply limiting what the government does will make the system work better. You will get the policing in the marketplace, and this is a major step in that direction.

Senator BOND. Moving from the specific to the general then, how meaningful is the $100,000 limit on deposit insurance? What is the impact of the current system of deposit insurance on the marketplace and has it had a distorting effect?

Mr. SEIDMAN. 99 percent of all the deposits that we handle in failed banks are fully protected, not only up to $100,000, but fully protected. They are fully protected primarily because that is a less costly way for us to handle the situation by transferring the whole bank instead of closing down the bank and liquidating it. So, in fact, the system is operating so that we have deposit insurance for all depositors in failed banks except for a very few small banks where we can't find anybody to take over the bank. That obviously eliminates depositor discipline to a great extent in the marketplace and we think that that is too bad.

On the other hand, depositor discipline is the reason that deposit insurance was instituted, to stop runs on the banks. So always when we talk about this question we sort of mount our horse and ride off in all directions, because we are trying to keep runs from happening to the banks and at the same time keep some discipline.

There is still some discipline in the marketplace. First Republic was ultimately rescued because there was a major run on that bank with money going out in the hundreds of millions in a short period of time. Even with all of these things and even though we have protected 99-percent of all depositors, there is still a marketplace out there that doesn't want to be involved with a failed bank.

Senator BOND. What do you think would happen to the banking system if, for example, we were to lower the $100,000 limit, or as some have suggested, if insurance was limited to certain types of deposits such as individual accounts and maybe very smallest business accounts? I am advised that no other country insures deposits to such a high level. But again, no other country has such a decentralized financial system and so many institutions.

Are we insuring the system or the depositors, or where should we go?

Mr. SEIDMAN. I think the key word is just what you said. That is, we are insuring the system. Federal deposit insurance was not created to insure the system, but it has ended up as the final resource to handle failed banks in a way that the system is not jeopardized. Whether you had the deposit at $2,500 or $100,000 wouldn't make a bit of difference with respect to that obligation. If Congress or others think that that is an inappropriate responsibility for deposit insurance, then I think Congress should consider who is going to take that responsibility or whether we are simply going to let our large banks fail and close if they can't meet—if they are insolvent. No other country does that. It will be a tremendous handicap in the international marketplace and, in fact, when I go to Europe the first thing I am asked is, are you still standing behind your banks? I am careful to say yes, because I don't know what the reaction would be if I took another position.

So I think that in talking about the deposit insurance system, you are talking about a far larger subject than just depositors. Because of the way the system has worked out, the lender of last resort is no longer the Federal Reserve, it is the Federal Deposit Insurance System.

Senator BOND. Thank you, Mr. Chairman. I appreciate your views, and when the study comes out on the system that you are making, we will obviously be most interested in seeing it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Sanford.

Senator SANFORD. Thank you. I did not have an opportunity to get here because of a conflict, and I have put my statement in the record, but I wanted to welcome you and to commend you for working out what I think was a very innovative and creative approach and to say publicly that I think you picked a very sound, extremely well-managed bank as your agent for this. All in all, I think that you and they are to be commended for doing this.

I would like to pick up where Senator Bond left off. We have how many banks in the FDIC?

Mr. SEIDMAN. How many banks do we insure? 13,000 some.

Senator SANFORD. Well, what is the system that you are trying to protect? In other words, what would it hurt if a few of those were just closed and liquidated?

IMPACT OF CLOSING A BANK

Mr. SEIDMAN. A great many of those, if closed, would hurt their local community if no banking services were provided. The very large banks if they closed, might well cause a real question about the safety and soundness of the whole system in the area involved.

Senator SANFORD. Well, you seem to be saying that you have expanded the concept or the scope of FDIC from insuring deposits to a much different concept, as a bank of last resort, protecting how much of the system? At what point will this last resort resource itself go broke if it takes on too much to protect?

Mr. SEIDMAN. That is a question that we think at this point we can answer by saying that we have the resources to handle what we see ahead of us. However, there is no question that there is a basic difference between our becoming insolvent and FSLIC becoming insolvent, because we have this broader mandate, maybe never directly given to us, but in effect agreed to by both the regulators and so far the Congress, that someone has to deal with major bank failures that may imperil the system.

Senator SANFORD. Well, to what extent has Congress participated in this expanded concept and to what extent perhaps—what additional steps perhaps should be taken?

Mr. SEIDMAN. The first time that this was really done in a very substantial way, I guess, was Continental Illinois, which was 4 or 5 years ago. Congress held hearings on that. There was some diversity of opinion. They didn't take any action. I think we have continued to follow that doctrine where all the regulators thought it was necessary. Certainly, anybody that looks at deposit insurance is going to have to examine that doctrine, I believe, and decide whether it is in the right place and being done the right way.

The Federal Reserve was clearly never created to handle insolvent institutions. It is a lender for liquidity purposes not for insolvent institutions. Therefore, there is a problem which we have visited by necessity, and we would be pleased to have Congress review it.

Senator SANFORD. Well, Congress, after the Continental Bank and the hearings, at best, simply acquiesced in what you had done.

Mr. SEIDMAN. I think that is correct—at least no action was taken.

Senator SANFORD. No action attempting to limit your scope, but no action in legal terms to expand it.

Mr. SEIDMAN. That's correct. The air was blue with some of the comments but no action was taken.

Senator SANFORD. My question really goes to the fact that if you make the case for protecting the system, should you make it in such a way that you then have the authority and the potential resources to truly protect it?

Mr. SEIDMAN. I think we have the resources at the present time. However, I think Congress would want to examine that and make sure that there was—if they want that to be done, that we have resources to do that. We do, of course, have borrowing power. If, indeed, there is a great danger to the total economy if we allow the system to begin to fail in parts, is it not then rather urgent that we put in place the legal authority to do that?

Mr. SEIDMAN. Well, we have the legal authority to do what we have done, because we have legal authority to move in and assist banks whose failure would jeopardize the system. So we have legal authority for what we are doing. Whether or not Congress contemplated that it would be used very often to save very large banks because of threats to the overall system——

Senator SANFORD. I will have to quit now, but it seemed to me that the authority was to protect—the charge was to protect the FDIC, and it is better to keep a bank going than to liquidate it and pay out, not the authority to protect the system. And I think that is an unanswered question that perhaps we shouldn't leave open.

Thank you, Mr. Chairman.

Senator GRAMM. Well, Mr. Chairman, I wouldn't wait around for Congress to lessen the scope of your mission.

I would like to begin by saying that I think the FDIC probably is the most efficient government agency. I think it is remarkable, the job that has been done by FDIC over the years, and I think the action you have taken in Texas fits right in line with that long history of working to protect the banking system, to protect our depositors and to protect your resources. I guess it is clear that the people of Texas, like the people of any State, would have preferred to have our own investors end up controlling our largest bank, but we understand you were trying to protect FDIC. Quite frankly, our primary concern is to have that bank making loans again, since our problem in jump-starting our recovery has been that while the economy is getting better, our financial institutions have been so weak that they spent much of their energies trying to keep their doors open rather than making loans to build new homes, new farms, new factories, to generate new economic growth.

I would also say that these people at NCNB do talk relatively good English, from my point of view. [Laughter.]

And that has helped.

But it is my impression, that since this transaction did occur, No. 1, it went smoothly, and No. 2, depositors accept it, and that No. 3, this financial institution, unlike the old, is out making loans, is out performing the function that we historically attribute to banks.

Is that your impression?

Mr. SEIDMAN. Yes, sir.

Senator GRAMM. Well, as I see it, that is not only something that is going to help the Texas economy, but it is going to help the banking problem in Texas, since the real solution to our financial problems, whether you are talking about banks or savings and loans, is really going to come through economic growth. And I don't think we have gotten the whole impact of the progress we have made already in Texas because while we have broadened our economic base, while we have cut our own employment level, the

multiplier impact of all that has been lessened by the condition of our financial institutions.

Do you see this action that you have taken with these two banks being the end of the big bank problem in Texas, assuming that this merger takes and that this institution is successful?

Mr. SEIDMAN. Certainly, the major problem is behind us, with the merger of those two banks and the two that we just did, plus First Savings. We have done five of the ten largest banks in Texas. We have put many billions of dollars into Texas. Out of the ten largest banks there, assistance has been rendered either by us or the private sector for eight. One can't guarantee how the other two largest will come out, but certainly, the major part of the problem is behind us. We believe that they are in a position now to do normal banking in Texas.

Senator GRAMM. Well, let me say, Mr. Chairman, that I wish some other State had the great honor of getting all this money. [Laughter.]

But we are grateful that the insurance fund was there for the rainy day that did come.

I would like to ask a final question. Everybody has talked about the merger between First Republic and InterFirst. And I guess, obviously, looking back it is easy to see that the merger was unsuccessful. A relevant question, however, would be is there any evidence that would lead you to be confident that things would have been better without the merger?

Mr. SEIDMAN. No, as I testified previously, I think the two institutions would have failed in any event. The fact that they were put together meant there was more capital and less operating expenses and a better product to sell. I would still make the same judgment today that I made at that time, that it was a reasonable chance, even though it didn't turn out right.

MERGER WAS A FAILURE

Senator GRAMM. So let me be sure I have it in focus. From a business point of view the merger was a failure, the guys that put up all the money lost their money, but from the point of view of the regulator and the FDIC, there's little evidence to substantiate the fact that the FDIC lost in the merger or that the banking industry lost in the merger.

Mr. SEIDMAN. I believe that is true. I have not seen any.

Senator GRAMM. Well, again, Mr. Chairman, I would just like to say to Chairman Seidman that we are blessed in having had from its very inception an efficient Federal Deposit Insurance Corporation. Quite frankly, I look at FSLIC and all their problems, I look at the FDIC's temporary problems, and I don't see a parallel between the two myself. I look at the huge contingent liability we have had over the last 50 years, and it is almost a miracle we have done as well as we have. With our problems at FSLIC and in the savings and loan industry and to a lesser extent to the banking industry, I think it behooves us all to go back and look and see what we have learned in the last 50 years and what we can do to be sure that these funds are always going to work as well as they have in the past.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Chairman Seidman, I have confidence in you and that helps shore up at least my view of what is happening here and what will happen in the future. I am concerned about the fact that we have just moved into a higher interest rate environment, and there has been instability, as you know, around the globe the last 2 or 3 days coming off the Federal Reserve Board's increase in the discount rate.

If interest rates that have now racheted up stay up at these higher levels or go even higher, how much does that tend to complicate you, the problems you are facing, and workouts and other troubled situations?

Mr. SEIDMAN. As far as the banking system as a whole is concerned, the interest rate risk is not great. We evaluate that all the time, and the interest rate gap in the banking system, as a whole, is not of great concern.

As far as the liquidation of assets, the higher the interest rate, the more difficult it is to sell the assets at reasonable prices.

Senator RIEGLE. So you can handle things in this higher interest rate environment reasonably well; that does not create a material new complication for you?

Mr. SEIDMAN. We believe that is so in general. There are specific exceptions. We don't believe that is so with respect to the S&L industry.

Senator RIEGLE. I will come to that in a minute.

How many other major unresolved bank problems do we have right now? I am not asking for names necessarily, but what is the number we are talking about?

Mr. SEIDMAN. In terms of the size of First Republic, we may have one, but we don't see any beyond that at this point.

Senator RIEGLE. Do you have other major banks that seem to be in a downward spiral, or are we at a point now where everybody's pretty well leveled out and may be on a slow improvement basis?

Mr. SEIDMAN. By and large, the major banks we have been looking at with some apprehension seem to be showing some improvement.

Senator RIEGLE. Now you testified a week ago in the House on the savings and loan problem. I think at that time, I've not yet read your testimony, that you gave an estimate of what you thought the minimum losses were that we now face in that system. And if my information is right, and I want you to correct me if it isn't, that you indicated something to the effect that you thought that the losses there were probably at least $50 million or billion as of today; is that correct?

Mr. SEIDMAN. Senator, what I said was that I don't know what the losses are in the S&L industry. I don't know how anybody can tell until you send people into the 500 and some insolvent institutions and make an estimate. When we have an institution that is insolvent, the first thing we do is send our liquidators in to find out what the loss is. The number I gave was in response to a question that I got from the House. That is, if these were banks and taking

the classifications of the assets that they have, and if the losses were the same as bank losses, what would be the loss on the 500 institutions that are both insolvent and losing money?

In doing that, we looked at only 60 percent of their assets. We excluded home mortgages because that is not a part of our regular calculations. We used our loss ratios, and with that, we came to about $50 billion. So we were actually only looking at 50-percent of the assets in the insolvent, unprofitable institutions and using our loss ratios.

Now whether that is correct for S&L's, I don't know.

Senator RIEGLE. Well, you have been in this business a long while. You are a professional accountant of top rank and so acknowledged to be. And it sounds to me as if you used what I would call a very conservative appraisal procedure, albeit it is one that you apply in banks, but it sounds to me like that is a very conservative one, and that if you, using that system come up with an outstanding deficiency or loss now of $50 billion, the likelihood is probably higher than that, certainly no lower than that.

That to me is significant. Is it your understanding that the same kind of understanding analysis has been done by the FSLIC people themselves to try to get that overall size up?

Mr. SEIDMAN. As far as I know, Senator, they have never published how they arrive at their loss. They may well have a similar thing, but we have not seen it.

Senator RIEGLE. If you were asked by the Congress or the executive branch to do an independent audit of the size of those losses, because you are in a parallel business that you understand, you wouldn't have any of the possible inherent conflicts of interest that someone might have who were enmeshed in the problem directly. If you were asked to put together a team to go in and do an arm's length assessment of the size of those losses and given the resources you needed, would you have the capacity to do that? Do you have the skill levels necessary to do that?

Mr. SEIDMAN. I would have to examine that in some detail. We are currently reducing our liquidation force because we are taking far fewer assets. We have reduced that force by over 1,000 people within the last 18 months, and we are continuing to reduce the force.

If we were to stop reducing the force—our plans are to reduce it, I think, 700 or 800 this year—and kept those people on, plus get some of the other ones back, we probably could organize, with FSLIC's help a force to look at that perhaps with GAO supervising it.

INDEPENDENT FIX ON THE SIZE OF THE PROBLEM

Senator RIEGLE. Mr. Chairman, my time is up, but I must say, I am attracted to the idea of really getting an independent fix on the size of this problem as fast as possible, and I think the FDIC probably has the capacity to do this, particularly because you have had a large liquidator staff, you are drawing it down. These are people who are professionals, you are professional. And it seems to me the arm's length assessment that was done over a short period of time using good solid accounting techniques, going in, looking at each

institution, nailing this down, so that we know precisely where we are, is the thing to do. After all, the U.S. taxpayer is really on the hook here, whether we want to admit it or not. And I think that at a minimum we owe the public accurate information. We owe it to ourselves to make the policy decisions that are going to have to be made early in the next administration.

So I would like to suggest, Mr. Chairman, that we consider that, because I think it is a way to really capture this problem in a fashion that no one has managed to as yet.

The CHAIRMAN. Thank you, Senator Riegle.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Nice to see you here today, Mr. Seidman.

Mr. SEIDMAN. Thank you.

Senator HECHT. Following through with what Phil, Senator Gramm said, I think the FDIC is a very, very efficient organization. It has done a great job, not just now, and unlike the other members sitting on this committee, I wish I had $1 for every hour the FDIC examiners have kept me awake at night over 25 years, because they have always been very tough and very efficient.

We are talking about Texas now. Let us be somewhat philosophical for the moment.

In my opinion, the Texas antiquated banking laws brought on this collapse. They are old; they are antiquated. And if we are going to insure deposits in every State, do you not think that it is time that States have to come up with realistic banking laws?

Mr. SEIDMAN. I believe the banking laws as they were in Texas did create additional costs for the FDIC. I have suggested that States that want to have unit banking and create additional risk for the insurance fund should pay higher premiums. Yes. I think it is a problem that needs to be addressed.

Senator HECHT. How many other States, in your opinion, off the top of your head, have antiquated banking laws?

Mr. SEIDMAN. Well, there aren't many left, because things are changing very fast, and unit banking laws—there are a few in the Midwest—but I would say overall, it is not more than 10 or 12 now.

Senator HECHT. Okay. Now following through and trying to prevent collapses in the future, is there anything you would recommend to be in the best interest of banking that is not being done in certain States right now that could contribute to other bank failures?

Mr. SEIDMAN. Well, we are studying that in this overall study on improving the system. We think that risk-based premiums are something that we should examine. Risk based on the State laws would certainly be an important factor. And of course, we are looking at a number of other things such as restricting the kinds of parties that have insurance, and so forth.

We have not reached any conclusions at this point, because we are trying to get the views of all the various parties together. We have been at it for 6 months, and we hope to be done by December.

INTERSTATE BANKING

Senator HECHT. Do you feel we should speed up interstate banking?

Mr. SEIDMAN. It is moving very rapidly at the moment. I think it has come along in a desirable way, because the States have made the decisions themselves. I think, in general, it is going well under current conditions.

Senator HECHT. When do you see fully interstate banking?

Mr. SEIDMAN. For all practical purposes, by about 1991, all the major States will be opened to interstate banking—or 1992—whatever it is. So we can see the time when almost all the major States will be into banking.

Senator HECHT. Wouldn't that be a very positive step that banks then could spread their risk to other States and not just be dependent upon one resource like energy, like in Texas, for instance?

Mr. SEIDMAN. I think it will be a positive step. It will increase competition. It will get away from the kinds of protection that have allowed some of the systems to weaken in particular States.

Senator HECHT. This protection is costing all the taxpayers money, because there is just no questions that it has contributed.

Mr. SEIDMAN. There is no question that when regulation allows weaker units to continue to work because they don't have competition, that it is ultimately going to cost somebody money—in this case, the taxpayers.

Senator HECHT. Thank you very much.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Sasser.

Senator SASSER. Yesterday the Fed surprised everybody by increasing the discount rate—well, it was on Tuesday actually that the Fed increased the discount rate in what was generally thought to be a very surprising move. I don't believe most people or most observers believed the discount rate would go up between now and November.

Today's New York Times contains a front page article on the effect that these rising interest rates are going to have on the holders of adjustable rate mortgages. That instrument has become perhaps the most popular means now of purchasing a home for homebuyers.

Now not much is said, however, about the so-called leveraged buyout financing. Much of this leveraged buyout financing, as you know, is on a floating rate. So many of these highly leveraged companies could well have a problem meeting these payments as interest rates go up and particularly if the increasing interest rates have an adverse effect on the economy, if they push us more in the direction of a recession. It appears to me the Fed's desire is to slow this economy down. I don't agree with that, but Dr. Greenspan and his colleagues at the Fed seem to think that we need to be slowing this economy down and cooling it off.

Now a number of commentators have warned that the banks in their frenzy to make any leveraged buyout loans could have embarked on a very dangerous path indeed. In fact, the "Economist," a very distinguished and highly respected periodical says that the banking industry's problems with these leveraged buyout debts

could be akin to Third World debt problems for some of our large banks.

Are the bank regulators watching this, Mr. Chairman? What's your feeling about this situation? Do you think it's as dangerous as some commentators would lead us to believe?

Mr. SEIDMAN. I don't think it is dangerous to the banking system. Most of the paper that goes into the banking system goes out rapidly through securitization or other means. We have looked at that in terms of interest rate risk and, while there is some risk, it mainly is not in the banking system. That paper has moved to other areas, but a good part of it ends up ultimately being financed by so-called junk bonds or high rate bonds which have not ended up in the banking system.

So we don't believe that overall it is a big threat to the banking system, but whoever holds the paper obviously has a risk for which, of course, they've got a higher return. However, there is a high risk there.

Senator SASSER. Could this represent a collateral threat to the banking system? In other words, if these people who are holding these so-called junk bonds, if these things suddenly turn worthless, then they're not going to be able to repay loans they might have to the bank.

Mr. SEIDMAN. Anything that affects the overall economy adversely affects the banking system because it is at the heart of the economy.

Senator SASSER. So it could have an effect.

Mr. SEIDMAN. It could have an effect but it is not a direct one.

Senator SASSER. Not a direct impact, in your judgment?

Mr. SEIDMAN. In large measure, that is correct.

Senator SASSER. Now a moment ago you indicated that you thought the worst was over as far as Texas was concerned. Chemical Bank in New York acquired another large Texas bank just a few years ago, as you know. This was the National Bank of Commerce. And according to the Wall Street Journal, some "unanticipated" problems have developed at the Texas bank. What about this? Do these unanticipated problems at the Bank of Commerce threaten Chemical, in your judgment?

Mr. SEIDMAN. We are not the direct supervisor of those. It is my information that there is no threat to Chemical.

WHAT SHOULD BE DONE WITH THE FSLIC PROBLEM?

Senator SASSER. With respect to the rising interest rates, we've got a serious problem here, as you know, in the thrift industry, a serious problem with the FSLIC. I just might ask you, Mr. Chairman, we're going to have to deal with the problem. Do you have any suggestions for us this morning with regard to how we might deal with the problem of the thrift industry or what could be done with FSLIC?

Mr. SEIDMAN. We are studying that problem. I guess I would say that the first thing that I would suggest is that we find out as accurately as we can what the size of the problem is, (2) decide who's going to pay for the problem, and (3) decide how we can fix it so it won't happen again.

Senator SASSER. I'm afraid that problem is so massive there's only one entity that can pay for it. That troubles me very much and another reason that I'm troubled by this uptick in interest rates, this is going to make the problem in the thrift industry worse. It's going to make our problem with the FSLIC worse. That's why in my view the Fed is overreacting to inflationary fears in raising these interest rates. That's one man's opinion.

Mr. SEIDMAN. I could only comment that interest rates were going up in the marketplace. I'm not so sure the Fed wasn't following rather than leading.

Senator SASSER. I think we both agree, Mr. Chairman, when that discount rate goes up a half a point interest rates are going to follow right up. There's no doubt about that.

My time has expired. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Seidman, what is the culpability of the directors of the First RepublicBank? I must say I approach this with a view that frequently as I see it directors don't seem to bear the blame that they should bear in these instances. What happens to them? What's their culpability in all this?

Mr. SEIDMAN. In every bank where there is a failure, we send in a special team to examine the behavior of the directors and determine whether they are liable for negligence or other activities for which it is appropriate for us to bring suit since we stand in the place of the failed banks. We will do that in this situation as we do in every other. That team will report whether or not they believe there is liability on the part of the directors.

Senator CHAFEE. Now can directors be liable not solely for malfeasance but for nonfeasance, for just cruising along accepting glowing reports from the officers and not delving deep enough into the situation and acting? Is there a liability in that case?

Mr. SEIDMAN. Each case depends on a close examination of how they behaved, the law involved, and whether or not there was a performance that was so impaired that under the law that applies they would have legal liability. In general, they are liable for gross negligence or anything beyond that, including insider abuse and fraud.

Senator CHAFEE. I set those off in a separate category—the insider abuse and fraud.

Some of these questions might have been asked of you before and if so I apologize because I wasn't able to be here for all your testimony.

Do you think there are any other U.S. banks that in the next 6 months are going to be in a similar situation as this one?

Mr. SEIDMAN. We have looked that over and I testified before that at this time we do not see any major banks beyond maybe one, or perhaps two, that we might have problems with. But at this time we can't identify any for sure.

Senator CHAFEE. When was the last time that a bank regulator prior to December of 1986 took a good look at First Republic affairs?

Mr. SEIDMAN. The primary regulator of First Republic is the Comptroller. I believe that his examination, when the merger took place, was about a year old or something like that.

Senator CHAFEE. Have you given a worst case estimate of the cost to the FDIC of the First Republic situation?

Mr. SEIDMAN. We have said that our present estimate, which is very difficult to arrive at, is somewhere between $2 billion and $3 billion.

Senator CHAFEE. Now does that mean you're going to be out that in the end or could you possibly recoup that?

Mr. SEIDMAN. That means our current estimate is that is how much we will be out because of this transaction. We are estimating that we will advance approximately $4 billion and we will recover enough so that the loss will be between $2 billion and $3 billion. That estimate is very hard to make because it depends on all kinds of things, the state of the economy, interest rates, Texas real estate, and so forth.

Senator CHAFEE. I appreciate that. What are your total reserves for a situation such as this? What is $2 billion to $3 billion out of how much?

Mr. SEIDMAN. We expect this year that our fund, as a result of this and everything else we've done this year, will be reduced somewhere in the area of $2 billion plus or 10 to 12 to 13 percent of our total fund. That would leave us with $15 billion plus, perhaps $16 billion as reserves.

Senator CHAFEE. So this is a pretty big hit.

Mr. SEIDMAN. It's a big hit. On the other hand, it reflects taking care of almost all the major banks in Texas. We don't see any other such hit on the horizon. As the Chairman said, if we had a major depression, obviously we could have other hits. But right now, looking at the system and at the banks, we don't see anything like this coming up over the next year.

Senator CHAFEE. My time is up. I want to thank you, Mr. Seidman.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Seidman, welcome, and as ever, we're pleased to have you here.

You and I were discussing the FDIC some months ago and we were talking about popular perception of the FDIC as insuring deposits and a broader role you have in insuring the system.

Could you expand a little bit on that? It's going to go to my next set of questions which relate to how much do we insure and where do we make a distinction. What kind of a distinction ought to be made between the original purpose, as I understood it, of insurance which was to develop depositor confidence versus the other part of it which is to inject a kind of discipline in the system. You and I talked a little bit about this, but I thought for the record it was also a very important issue for us to understand.

Mr. SEIDMAN. I have just said, Senator, that we in fact protect 99 percent of all the deposits we handle in failed institutions. We do that because it is primarily the lowest cost way for us to handle it

and, therefore, we have expanded beyond, let's say, small depositors.

In addition to that, we have become the resource for handling very large failed institutions where it is believed that allowing the institution to fail would jeopardize the system in the region or in the country as a whole.

Senator WIRTH. Too big to fail? Those institutions are too big to fail.

Mr. SEIDMAN. They actually do fail. In the First Republic case, 41 banks failed, but the depositors of those two big institutions were protected. So someone has called it a bailout and I call it a shutout. The holding company creditors and shareholders were shut out, but the depositors were protected. That was done because it was felt essential to protect the system both in Texas and in the region and that the cost to the FDIC in allowing that institution to actually close down would have been far higher.

So we have become, as a result of both the cost that we incur when a very large institution fails and the potential jeopardy to the system, sort of the lender of last, last resort, and the Fed has become the lender of next to last resort.

Senator WIRTH. So in effect, the role of the FDIC has changed or has evolved from being one of focusing purely on investor confidence for which it was originally set up. The FDIC has become in effect a kind of insurer of the whole system.

INSURER OF DEPOSITORS, NOT INVESTORS

Mr. SEIDMAN. We have become an insurer of depositors, not investors. Investors are losing their money as they are going to in First Republic. We have become an insurer of the depositors in large systems, including those above $100,000 if necessary to protect the system.

Senator WIRTH. So very large depositors are insured as well in the system?

Mr. SEIDMAN. They are not immediately insured but our practice has been to protect them, that is correct. We do the same thing with small banks to every extent we can.

Senator WIRTH. Let me ask you about how this relates to the legislation which is changing the powers of banks. In effect, what you're saying is that very large depositors in these institutions are going to be insured, that somehow the Federal Government through the FDIC and ultimately the taxpayer is going to end up insuring these very large depositors.

Now what happens if these large institutions find themselves getting off into very extensive ventures of underwriting new issues that fail, getting involved in a securities venture that fails? Do we end up in effect having the FDIC insuring those activities as well?

Mr. SEIDMAN. No, sir. That is the crucial importance of what we did in First Republic with the bridge bank authority we had. We did not protect the holding company. Those kinds of activities would be either in a holding company or in a subsidiary of the bank. They would not be in the bank under any proposals that are before the Congress now. Therefore, if there were a securities subsidiary of First Republic, it would be left in the failed First Repub-

lic Holding Company and would not receive any protection from the deposit insurance corporation.

Senator WIRTH. And who knows where that line is? Do you all inspect that bank to see where that line is or are there accounting rules that say you are not supposed to go across this line? How do we who are the stewards allegedly of some kind of budget up here—how do we know that we're not insuring the activities of the holding company?

Mr. SEIDMAN. You have to rely mainly on us now to do that and, frankly, in some cases in the past we have not kept that line very firm.

Senator WIRTH. What does that mean; we have not kept that line very firm?

Mr. SEIDMAN. That means that we have allowed banks that were undercapitalized to pay dividends to the holding company even though the capital in the bank was insufficient. We believe that that is a practice that should not go forward, cannot go forward if banks are in the securities business.

Senator WIRTH. What kind of mechanism do you have for policing that line if you say that was not being done well in the past? What kind of new resources or capabilities do you have for doing it in the future? It would seem to me that that future policing becomes even more important with a whole variety of new powers being given to banks.

Mr. SEIDMAN. It does. In the past, very frankly, the view was, particularly of the Federal Reserve, that the bank and the holding company were the same. We believe that that view is now being changed by what happened in First Republic with the support of the Federal Reserve, and that it is vitally important that henceforth all parties agree that banks that are not properly capitalized and not earning money will not pay out funds to their owners no matter who they are.

Senator WIRTH. Has the Federal Reserve changed its policy in considering banks and the holding companies being the same?

Mr. SEIDMAN. Well, I'm afraid you'll have to ask them that, Senator. To some extent, they certainly have in that they supported this First Republic transaction. Whether or not their view that the whole system has changed from the way they previously viewed it, I would not be able to answer for them.

Senator WIRTH. What kind of resources do you have now to make sure that the policing line is different from what you had earlier?

Mr. SEIDMAN. Well, it is less resources than resolve. We have to resolve that we're not going to let that happen. You can't do it all at once because having let it happen for a while you have to give people time to adjust. But what it takes is the resolve on the part of all parties that this is the way we want to run the system.

Senator WIRTH. And what do you do, just send out a memo saying everybody be a good guy and discipline yourselves and make a separation between these?

Mr. SEIDMAN. We have said to the banks that we regulate that we are going to enforce this rule. A number of banks that are involved are regulated by the Comptroller or by the Federal Reserve. They would have to have the same resolution.

Senator WIRTH. Mr. Chairman, I appreciate having a little bit longer time here. It seems to me that this is one of the crucial issues that we are facing in the whole area of bank deregulation. How do we assure that the insurance that is made available to institutions effectively supported by the government and by the taxpayer—how do we make sure that that doesn't spill out into a variety of other activities so that we are trying to make a "risk-free" environment and lose entirely any kind of discipline of the marketplace. And what Mr. Seidman is telling us is that in the past the FDIC was not very good at doing this or had not really made that distinction as clearly as it should have. It seems to me that it's appropriate for us to have a pretty clear indication of how that separation is being enforced and is being disciplined. Maybe just sending out a memorandum to people and telling them that that's how you intend to manage the system is enough. I would think that there would be a lot of other people out there, however, who would love to have that merger between commercial ventures and banking and to try to have a risk-free environment. Maybe more than just resolve from the top is appropriate to assure that that's going to happen.

Mr. SEIDMAN. We certainly wouldn't object to that. To us, that is key to the way the banking system is going to develop. If the banks are going to be in other activities. They should be walled off from the deposit insurance part either in a subsidiary or in the holding company. The bank should not be allowed to support it unless they have excess capital. We hope you will address that.

The CHAIRMAN. Chairman Seidman, as I understand it, you've changed your position now from what you had before. Perhaps I'm wrong. I don't want to be unfair. I understood that you originally felt that the security affiliate could be a subsidiary of the bank instead of an affiliate under the holding company. Is that right?

Mr. SEIDMAN. It could be either as long as it is walled off from the bank.

The CHAIRMAN. The only way to really wall it off so that the bank isn't directly affected is to have the holding company own the affiliate and therefore the bank would have that extra protection, would it not?

Mr. SEIDMAN. We believe the protection can be the same in either case, Senator. However, your views were clear on that. We have agreed that, given your views and the way you wanted to do it, that we would not object.

The CHAIRMAN. But you're an eminent accountant and you know if it's a subsidiary and it goes under and it loses money, then the owner, which is the bank, takes the losses itself. If the holding company owns it, then the bank is free of the loss. Isn't that right?

Mr. SEIDMAN. I would not agree with that, Senator. If the subsidiary is a securities company and it goes broke, the bank loses its investment in that, but that can only be made out of excess capital so it does not jeopardize the bank's capital.

The CHAIRMAN. Nevertheless, it's out of the capital the bank has, whereas if it's owned by the holding company, it's the holding company and not the bank that takes the hit.

Mr. SEIDMAN. But, Senator, the bank can take its excess capital, give it to the holding company, and that can be put into the subsid-

iary of the holding company. We believe it comes out the same. We have sort of given up on that issue, not because we think we're wrong, but just because the overwhelming power of the chairman was too great for us.

The CHAIRMAN. I'm glad you've given up.

NATIONALIZING BANKS

Let me get into another area where there's been a cheering section by Senator Gramm and Senator Hecht and others for nationalizing the banks as fast as we can. I want to express my very strong disagreement with that. In this instant case, where First Republic of Texas was taken over, there were Texas interests that were bidding also. Did you give any—including, as I understand it, one headed by former Senator Tower who used to sit right here, as you know—and the management of the bank that wanted to make a bid. I understand why you made the selection you did and I think it was a good selection and you made it on the basis of competition and so forth.

But in selecting a merger partner, was there any weight at all given to local bidders because of the fact that (a) they were there (b) they knew the market thoroughly (c) they had the interest of Texas in a little different way than somebody from North Carolina would have?

Mr. SEIDMAN. Yes, there was, Senator. The Board agreed that all things being even we would favor a local bidder because we thought that would be the most viable result. All things weren't even. And even those that were local bidders were basically hiring outside investment bankers to raise money throughout the country. So it is a little hard to know really who the local bidder is. They were led by local people but the money was going to be national money.

The CHAIRMAN. Now I just wanted to make the point that there's no question that there is value in having a large bank that has diversified holdings and that adds an element of stability. On the other hand, there are very strong values in having locally owned operation that has an interest in the community and knowledge of the community and is concerned with the community and that has to be balanced.

The FDIC obtained 80 percent of the equity in this company but your shares are nonvoting shares as I understand it. 100 percent of the vote is with NCNB. Why, if you initially invest nearly $4 billion in NCNB do you forego your voting rights?

Mr. SEIDMAN. Well, it is illegal, I guess, for us to own voting stock. However, we have the power to remove directors and they can make no major decisions without our consent. So we believe we are protected.

The CHAIRMAN. Would you recommend that we change that law?

Mr. SEIDMAN. Yes.

The CHAIRMAN. And permit the FDIC to have voting rights?

Mr. SEIDMAN. Yes.

The CHAIRMAN. I think that's a very good recommendation.

Mr. SEIDMAN. We use a lot of subterfuges to get around it now. It would be nicer to do it directly.

The CHAIRMAN. This comes as a delightful surprise. Will you write me a letter so that we can go to work on that? We don't have much time left and I have very little time left, but what time left there is I'd like to make it productive and this sounds like a good suggestion.

Mr. SEIDMAN. I'd be happy to do that, Senator.

The CHAIRMAN. Now the FDIC still holds shares in Continental Illinois. Should they expect to be able to sell their 80 percent stake in NCNB? You've held Continental Illinois for 4 or 5 years and you can't sell that. Can you sell this?

Mr. SEIDMAN. We expect that NCNB will exercise its option to buy the shares from us. It has every incentive to do that. So it is somewhat different from Continental Illinois. As you know, in Continental Illinois, we sold about 30 percent of our interest and we believe we will sell the rest in the near future. If "Black Monday" hadn't come along, we probably would have had it sold by now.

RECESSION OVERDUE

The CHAIRMAN. Well, I hope another "Black Monday" doesn't come along. We're overdue for a recession, not a deep recession and not a deep depression, but a recession would give you an awful lot of trouble, wouldn't it?

Mr. SEIDMAN. Mr. Chairman, that depends on what kind of a recession we have. We had a sharp recession in the 1975–76 period and it had a very minor effect on banks. It was short and sharp and it didn't really affect the banking system. If we had a long and deep recession-depression, it would clearly affect the banking system.

The CHAIRMAN. Not only the depth and length of the recession, but it was the nature of the system between then and now. The difficulties have come not with the 1982 recession, for example, or 1986, 1987 or 1988, if you have a combination of the problems that we've developed within the banking system and a recession—we've never really had them together—it seems to me you'll have a really tough problem—not you, but all of us.

Mr. SEIDMAN. Well, I guess none of us know how long we'll be here, but I think the banking system, much of it, has learned that overoptimism and overconcentration is risky. Certainly Texas had overconcentration and overoptimism. My home State has gone through a few recessions. I think it has have learned a few things about that and I think many bankers have around the country. So, I don't think we're liable to face the Texas situation in a good many other parts of the country.

The CHAIRMAN. I couldn't disagree with you more. I think that we are much too optimistic now. Business debt has never been as big as it is. It's over $4 trillion. Leveraged buyouts have made many businesses and corporations far more vulnerable than they've been in the past and, after all, a lot of those loans come from banks. So I think that we're in a situation that could be very dangerous come a recession.

Mr. SEIDMAN. Debt levels are very high. I certainly agree with you, sir. I think the trends have been better recently, but there is

no question debt levels are very high. Eventually if we have a problem with that it will affect the banking system.

The CHAIRMAN. Now the Federal Home Loan Bank Board has requested sense of the Congress language affirming the full faith and credit of the United States stands behind the promissory notes issued by FSLIC with a ceiling of $16 billion outstanding. Both the Chairman of the House Banking Committee and I are resistant to that to some extent, but a strong case has been made for that. You don't have that guarantee, although you're in good enough shape so that you don't need it at the present time. You may or may not need it in the future.

Do you think it would be a wise move under present circumstances for the Congress to provide that full faith and credit in a continuing resolution?

Mr. SEIDMAN. In general, Mr. Chairman, I think it is unwise to do stopgap measures which are going to cost the government money until we find out the size of the problem and how we're going to fix it. Unless it is such an emergency that it is felt necessary, I would like to see a more overall approach to the situation.

The CHAIRMAN. I would agree to that except that as I understand it, without that full faith and credit assurance, it's going to be very hard for FSLIC to do the job it should do in closing losing insolvent institutions. They need that and that would be a big help to them according to the Chairman of the Federal Home Loan Bank Board.

Mr. SEIDMAN. Well, I'm sure that $16 billion of aid would be of help to them and I think they ought to get help. What I'm worried about is providing them with help without ensuring that the system is such that it won't get worse.

PRIVATE TAX RULING BY THE IRS

The CHAIRMAN. Now nobody has asked about the tax ruling that was so helpful in this case. Press reports indicate that a private tax ruling by the IRS for NCNB was an essential ingredient in their winning bid. Would you please describe that tax ruling and why it would make the bid more attractive?

Mr. SEIDMAN. The ruling essentially allowed the NCNB to offset our assistance, which is taxable for us. It's not for FSLIC. It has a special provision. So it really just allowed them to offset the losses against the assistance that we gave plus allowed them to use the excess losses against future income.

Since we get a part of the earnings of that bank, a substantial proportion of that is going to actually go to us instead of to them. As far as the ruling is concerned, it was a ruling which they went to the IRS and got. We were not involved except to tell the IRS that they were an active bidder.

The CHAIRMAN. People never look at it quite this way, but this is a zero sum game. If they're saved $1.7 billion, that's something that doesn't go into the Treasury and it has the same effect on the budget as if we were spending it.

Mr. SEIDMAN. I certainly agree with that, Mr. Chairman. The amount is somewhat more like $700 million in tax savings of which we will get some amount, depending on future earnings, 30 to 40

percent. Since we are included in the budget, the probable net down the road is under half a billion, or in that area.

The CHAIRMAN. They put in $210 million and they get a tax saving of something like a $½ billion. They also get the benefit of being able to double their assets, plus if it's a success they win and if it's not a success you pay.

Mr. SEIDMAN. Well, yes, sir; but the problem——

The CHAIRMAN. Not you pay. We pay. The taxpayer pays.

Mr. SEIDMAN. The insurance fund is an insurer. What's happened here is that the house has burned down. We have to pay for that. Nobody is going to come in and pay for the house that has burned down. So there is an insurance loss here that the insurance fund, unfortunately, has to pick up. That is the reason why it looks so disproportionate because we have to pick up the loss.

As far as the capitalization of the bank is concerned, they put in 20 percent and we put in 80 percent, exactly proportional to our interest. When they buy us out, they will have to pay for their 80 percent plus our share of the earnings and a bonus that will cost them well over a billion dollars.

The CHAIRMAN. My time is up. I'll only take a minute or so, but you say they put up 20 percent, $210 million; and you put up $4 billion? That looks to me like you put up 95 percent and they put up 5 percent.

Mr. SEIDMAN. We put up $800 million for our share of the capital. The rest that we put up was to take care of the losses in the bank because the house burned down, because the previous management made mistakes.

The CHAIRMAN. Let me ask you this. Why wasn't this tax opportunity shared with the other bidders?

Mr. SEIDMAN. We operate on a private-sector bidding basis. Each bidder evaluates his tax position and deals with the IRS on its own. We take the bid that the private sector bidder gives us based on his estimate of what the tax results will be.

The CHAIRMAN. How is ownership defined so that the loss carry forward provision can be used?

Mr. SEIDMAN. I understand this is a section G reorganization and it qualifies under that.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

To follow briefly on some of those numbers, this was a $4 billion hit on the FDIC, is that right?

Mr. SEIDMAN. The initial outlay was $4 billion. We expect the ultimate cost, which is very hard to estimate, to be $2 billion to $3 billion.

Senator WIRTH. Where does that show up in the Federal budget?

Mr. SEIDMAN. It only shows up ultimately in the fact that at the very end of the budget they add in either our deficit or surplus and treat it as though it is part of the budget even though it has nothing to do with it.

Senator WIRTH. Whether it's at the very end of the budget or at the very beginning of the budget, when Senator Proxmire and I and other members of the Senate have to look at a budget, that budget has in it a $4 billion debit and a $4 billion expenditure that goes to the FDIC, isn't that the case?

Mr. SEIDMAN. Less the income we have.

Senator WIRTH. Maybe it's $3.5 billion.

Mr. SEIDMAN. There's no argument. It goes into the bottom line of the budget.

Senator WIRTH. It goes into the bottom line of the budget. Now from the taxpayers' perspective, the taxpayer assumes that this is all coming out of the FDIC, but in fact what happens is that because there's $4 billion that has to go to the FDIC we have to find that $4 billion someplace else. And that $4 billion could well come out of education or health care or whatever. Is that not right?

Mr. SEIDMAN. That's the way the system works. However, the system, in my view, is wrong. It should never be added in because the——

Senator WIRTH. So you think the FDIC should be off budget and totally separate?

Mr. SEIDMAN. It is a separate fund. It does not come from tax funding. It was added in when we had a surplus because somebody thought it would be nice to have us in under those conditions.

Senator WIRTH. So you're saying it should be off budget.

Mr. SEIDMAN. I believe it should be off budget, yes.

Senator WIRTH. I want to tell you that when many of us voted to cut the funding for Star Wars it was because of the problems you had at FDIC, so I was hoping you would tell the President that there's less money in there for Star Wars because of the problems of the FDIC.

Mr. SEIDMAN. If he asks me, I'll be happy to inform him.

HOW STRONG ARE THE FINANCIAL INSTITUTIONS

Senator WIRTH. Let me ask you about just how strong you think the financial institutions are. You said earlier that you think there's maybe one other major institution which we may have a problem with I understand.

Mr. SEIDMAN. One or two I said.

Senator WIRTH. OK. And the total reserves at the FDIC are about $18 billion?

Mr. SEIDMAN. They were, at the beginning of the year, yes.

Senator WIRTH. And we've used up about $4 billion of that?

Mr. SEIDMAN. Net $2 billion.

Senator WIRTH. And we've got a couple of other big institutions to go.

Mr. SEIDMAN. Not for certain. It is possible.

Senator WIRTH. There's a possibility. Now we have some other problems out there on the horizon, however, and I just want to get your assessment of how all of these fit together.

First, Third World losses and how banks are treating those and the relationship between their reserves and their capital. It's my understanding that until 1992 banks are allowed—is this correct—that banks are allowed to treat their reserve funds as part of capital? Is that correct?

Mr. SEIDMAN. Under the risk-based capital system—it hasn't been adopted yet——

Senator WIRTH. But that will change in 1992?

Mr. SEIDMAN. Well, it changes gradually and after that reserves will not be part of primary capital.

Senator WIRTH. And with that coming down the line, we know that a lot of our financial institutions have a very significant exposure in terms of Third World debt that realistically they're not going to get paid back for. Isn't that right?

Mr. SEIDMAN. No one can tell whether they're going to be paid back or not. The real question is whether that debt can be serviced or not.

Senator WIRTH. Well, even servicing the debt is enormously difficult.

Mr. SEIDMAN. That is correct.

Senator WIRTH. So we've got a real problem with that Third World debt servicing and that will be exacerbated after 1992 because of the change in the way in which reserve requirements and capital are treated from an accounting perspective, correct?

Mr. SEIDMAN. That will affect probably the 25 largest banks in the country. It will not affect most small banks.

Senator WIRTH. But the big banks, which are the ones that are "too big to fail" are going to have a problem?

Mr. SEIDMAN. Too big to allow the depositors to lose.

Senator WIRTH. OK. Too big to allow the depositors to lose. The debt problem is going to be out there, but from the perspective—from your perspective and from accounting, that's going to get worse in 1992, even if we continue to bump along as we are today, in 1992 they're going to take a really significant hit. Is that right?

Mr. SEIDMAN. Well, much of that depends upon what the Federal Reserve does in requiring capital at the holding company level. The banks themselves, by and large, are much better off. It is the holding companies that are going to be really deficient in capital. We have taken the position, that the international agreement applies to banks and not to holding companies. Also, we have taken the position that we don't protect holding companies and we don't care what their capital is.

Senator WIRTH. This gets us right back to what we were talking about earlier about the separation between banks and holding companies and how the Federal Reserve is going to interpret that and you're suggesting you're a lot more stringent than they are about that and we'd better be very careful about how the Federal Reserve treats that. That's what you're telling us in fact.

Mr. SEIDMAN. I'm saying we need to be very careful that banks don't support holding companies unless they have the money to do so.

Senator WIRTH. I understand. Let me add another piece to this. It's my understanding that the commercial banks annual writeoffs rose from about $6 billion to about $17 billion, is that right?

Mr. SEIDMAN. In 1987, that's correct.

Senator WIRTH. So we've had a very significant writeoff of losses of commercial banks.

Mr. SEIDMAN. Increase in reserves, that's correct.

Senator WIRTH. Okay. And we've got this significant problem internationally.

Mr. SEIDMAN. Well, the problem is much better than it was because they took these reserves. In other words, they've got a big hit

behind them. If these countries, for instance, can only support 70 percent of their debt and that's all they can service, and the banks are reserved against that, they would show no loss if, in fact, the countries only service 70 percent of their debt.

Senator WIRTH. And we've had no recession in this country. A recession would exacerbate the problems significantly?

Mr. SEIDMAN. We have a depression in Texas and Louisiana and Oklahoma and Colorado.

Senator WIRTH. What's your assessment, given the situation in Texas, given the broader issues as they relate to the international debt problem, and the fact that an awful lot of commercial banks have taken significant writeoffs? What should this Committee to be particularly concerned about.

Mr. SEIDMAN. I think the biggest problem in the financial system right now is the problems with the insolvent S&L's that are operating in the financial system. That distorts the entire financial system. That is problem number one.

Second, while we see improvement in the LDC loans, clearly that problem is not behind us yet. That is a problem which the banks have been addressing, but it is still a matter of concern.

Third, the banks are handicapped in their competition because much of their basic business has moved to other unregulated entities. As long as they are operating under an antiquated regulatory system they will gradually erode their capital and they will be unable to attract new capital. Therefore, it is vitally important that we deal with that.

Finally, it is important that we deal with the deposit insurance system in a way that institutions can't borrow on the credit of the United States and do whatever they want with it. All of those things, I think, need to be addressed.

Senator WIRTH. That latter is what we started out with and I couldn't agree with you more and I think that's something that we really have not attended to as carefully as we should. We're not going to create a risk-free economy. That's preposterous to think that we would.

Just one final item if I might, going to the first point you made on insolvent S&L's. The FSLIC fund is going to have to receive some kind of taxpayer money. Is that right?

Mr. SEIDMAN. I haven't made a judgment, because I don't know what the size of the problem is. I know it's large. I think you have to know that, to know how you're going to work it out.

Senator WIRTH. But you're worried the most about the great number of insolvent S&L's and that's a problem one would extrapolate from that to say obviously the FSLIC problem is going to be a lot bigger than the funds the FSLIC has.

Mr. SEIDMAN. I would imagine so.

Senator WIRTH. So we're going to have to have taxpayer funds going into that.

Mr. SEIDMAN. It would appear so.

Senator WIRTH. What interests me, Mr. Chairman, is the political problem that we may get into. Here we have a lot of FSLIC problems and an awful lot of commitment of FSLIC funds going into two or three States right now. Isn't that correct?

Mr. SEIDMAN. No. Their problem is much broader than two or three States. Their problem is much more national.

Senator WIRTH. Where have the major FSLIC bailouts been?

Mr. SEIDMAN. California, Texas, Florida, they've had some in other places. If you look at a map and mark out the insolvent S&L's, it's fairly broadly around the country, maybe in a third to a half of the States, something like that, although it is concentrated in Texas.

Senator WIRTH. And the dollars have been spread very broadly, too, or are they predominantly in Texas?

Mr. SEIDMAN. I can't answer that. Clearly, the largest dollars are in California and Texas.

Senator WIRTH. I just hope that when we get to the point when we've used up the FSLIC funds helping our brethren in California and Texas that when the time comes that problems are going to hit elsewhere—they may hit Wisconsin, although probably not, but they may hit in Illinois or they may hit elsewhere—that we get the political help that's necessary from those States that have been bailed out. The point of that is some of our colleagues have said very clearly that they would never vote for any kind of taxpayer money to go into the FSLIC problem and many of those statements have been made by individuals whose States are currently aided by the FSLIC which has money in it. Now what are they going to do, having been bailed out by the FSLIC, used up FSLIC money, if the problem hits elsewhere and there's no FSLIC money left over.

The CHAIRMAN. I think the answer is that we have pledged the full faith and credit of the United States Government and when it comes to a situation where either FSLIC or FDIC can't do it, there's just absolutely no question in my mind, Congress will have no choice and I think they will get a 535 to nothing vote in favor of our fulfilling our word.

Senator WIRTH. I hope that that's the case, but I can imagine there are going to be some who have already made a point on the record of saying that this is all FSLIC and this is all insurance money and when that's occurred and when we get around maybe to some other problems I just hope that they're there as well.

The CHAIRMAN. Well, I don't think they will be as frank as former Governor Long was when he said when he was confronted with a situation like that, he said, "I lied."

[Laughter.]

Senator WIRTH. Thank you very much, Mr. Seidman.

The CHAIRMAN. Chairman Seidman, I just have three more questions.

In this case, the FDIC was able to assist the acquisition without being forced to guarantee the assets of the holding company's creditors.

RECOMMENDATIONS

What legislative changes would you recommend to make it clear in the future that the creditors of the holding company are not able to get back inside the protective umbrella of the insurance fund?

Mr. SEIDMAN. I believe that legislation should address the type of transaction that took place here—namely, our recently introduced Emergency Consolidation from legislation. I think that would be appropriate. I think it ought to be made clear that banks cannot support holding companies if they are not properly capitalized.

The CHAIRMAN. Press reports indicate you also received bids for the First Republic management, Wells Fargo Bank, Citicorp, and possibly one or two others. Why did the NCNB management's bid prevail over each of these other bids?

Mr. SEIDMAN. We went through a two-step process. First, we determined whether the bid was a viable bid. That is, whether we thought the surviving bank could succeed. That got us down to three bidders. We then looked at the effect on the system, the cost to the FDIC, the capability of the management, and the viability of the suggestion. NCNB was considered the best bid and the lowest cost bid.

The CHAIRMAN. There was some talk that FDIC might be sued because they decided on NCNB instead of another bidder. Has that surfaced in any way? Is there any indication of a suit?

Mr. SEIDMAN. We have not been sued on that basis. We've been sued by some in the holding company who thought that we shouldn't have control of all the banking assets. However, to my knowledge, so far we have not been sued by anybody who said we should take a different bid. No.

The CHAIRMAN. Would you provide for the record the staff analysis and Dillon Read's analysis of the competing bids?

Mr. SEIDMAN. Yes, we will do that. We have a summary of that here and I can provide it to you.

The CHAIRMAN. Fine. We'd like to have the summary.

Mr. SEIDMAN. All right.

[The summary referred to follows:]

Comparison of Proposals for the Assisted Recapitalization of First RepublicBank Corporation

The FDIC received five final bids for the recapitalization of First Republic with FDIC assistance. This document presents the staff's recommendation, and details the strengths and weaknesses of the proposals.

Staff Recommendation

The staff of the FDIC recommendeds that the NCNB proposal be accepted. The NCNB proposal clearly meets the threshhold tests concerning the viability of the ongoing institution and the ability to complete the transaction in a timely fashion. Furthermore, the NCNB proposal is the least costly of the bids received.

While the Wells Fargo proposal also meets the threshhold tests, it suffers from both a high cost to the FDIC and from Wells Fargo's position that the FDIC relinquish considerable control over key aspects of the resulting entity.

In the First Republic/Drexel proposal, there is considerable uncertainty with regard to the threshhold issues of viability and the ability to complete the transaction. Providing comfort on these issues would require imposing considerably higher costs on the FDIC. Also, this transaction would extend the FDIC safety net to holding company creditors and shareholders.

It the consensus of staff, and other regulatory agencies, that both the Lone Star and Gaucher proposals do not, at this time, provide a minimally acceptable level of viability.

Comparison of Strengths and Weaknesses of Proposals

NCNB

Strengths

+ Lowest cost solution

+ Resulting entity viable

+ High probability of completing transaction

+ Strong management and most time spent planning and preparing for transaction

+ FDIC recourse to arbitration provides ability to check transfer of loans to bad asset pool.

+ FDIC oversight of management of bad asset pool

+ Support of prominent Texas business interests

Weaknesses

- Low initial outside capital contribution (although to gain full ownership, NCNB must contribute a total exceeding $1 billion.)

- Buyout option means that under poor economic conditions the FDIC may need to look to other sources in order to transfer its remaining interest.

Wells Fargo

Strengths

+ 100% outside initial capital contribution of approximately $1 billion.

+ Strong management team - proven ability to turn around an acquired institution

+ Resulting entity viable

+ High probability of completing transaction

Weaknesses

- High cost arising from steep incentive fees and restructuring costs, among other factors.

- Lack of FDIC control over transfer of loans to bad asset pool

- Lack of FDIC oversight of management of bad asset pool

Comparison of Strengths and Weaknesses of Proposals

First Republic/Drexel

Strengths

+ External capital

+ Support of Texas business community.

Weaknesses

- High cost to FDIC

- Marginal viability of restructured institution

- Uncertainty concerning ability to complete restructuring

- Protracted time period needed to complete restructuring would result in continued deterioration of franchise and would delay the stabilizing impact on southwest, and perhaps national, banking markets.

DILLON, READ & CO. INC.

SUMMARY REVIEW OF PROPOSALS

First RepublicBank Corporation

Strengths: Only proposal with a cap on FDIC assistance.
Texas community support.

Weaknesses: Potential capital weakness in restructured institution; under plausible scenarios much of the new capital could be lost.
Uncertainty with respect to the time and cost of completing the exchange offers and the stock offering.

Feasibility: Possible feasibility.
Problem assets may exceed the bank's estimate; with additional losses which will eliminate new equity.
Uncertainty of successful exchange offer and stock offering.

Est. Cost: $2.4 to $3.6 billion asssuming $7.5 billion of problem assets.

NCNB Corporation

Strengths: Very low funding and collection costs.
Tax-sheltered investment return.
Strong institutional commitment.

Weaknesses: Larger acquisition than any attempted by NCNB in the past.
FDIC must invest $840 million, increasing its outlay.
FDIC will be faced with a $4 billion further outlay in 1992 when pool assets may be put.
NCNB has an option but not an obligation to buy, increasing FDIC's risk.

Feasibility: High feasibility.
NCNB's initial capital investment of $210 to $240 million can be easily financed. Strong commitment at the most senior levels of NCNB.

Est. Cost: $1.4 to $2.6 billion, assuming $7.5 billion of problem assets plus 40% - 50% of additional classified assets.

Wells Fargo & Company

Strengths:	Maximum management experience and financial resources. Full and certain provision of $1 billion in new private capital. Potential for important tax benefits. No later asset puts or other major outlay requirements.
Weaknesses:	High cost of carry. Very high incentive fees on problem asset collections.
Feasibility:	High feasibility. Wells Fargo has the ability to invest the capital and management to successfully operate the First RepublicBank system.
Est. Cost:	$2.5 to $3.5 billion assuming $7.5 billion of problem assets and no tax benefits, plus 40% - 50% of additional classified assets.

The proposals made by the Lone Star Partners and by Michel Gaucher were eliminated because of their very low feasibility.

The CHAIRMAN. In the period after the announcement of the takeover by NCNB, the price of their stock rose by nearly $5 or over 20 percent. Is this a positive reaction from the stock market? Does that constitute evidence that the FDIC did not get enough from the NCNB bid and did not drive a hard enough bargain?

Mr. SEIDMAN. We were pleased to see the stock rise because we wanted the market to make the judgment that this was a viable transaction. Other bank stocks have risen in Texas as a result of that. First City was able to sell all of its stock that was held by its underwriters yesterday and that's partially the result of that. We meant for this to be a good deal for both sides because that's the only way it could succeed.

The CHAIRMAN. I notice that at the time the bailout was announced there was speculation that this could be very, very risky and that it could have an adverse effect on a number of other competing banks that have moved in, that there were some big boys in the game now in Texas, Chemical Bank, and one or two others, and that they were all aggressive and that at best it was questionable as to whether or not this would work out.

But it seems with the increase in the stock market that's not the judgment of the investors at least.

Mr. SEIDMAN. That seems to be the judgment of the market, that it is a sound transaction.

The CHAIRMAN. Thank you very, very much, Mr. Chairman, for your fine testimony. It was very helpful.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

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